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Developing a Strategy for Jordan in the WTO Non-Agriculture Market Access Negotiations

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Abbreviations and Acronyms

ACT	Agreement on Clothing and Textiles
AFTA	Arab Free Trade Agrement
ASEAN	Association of Southeast Asian Nations
DDR	Doha Development Round
EPZ	Export processing zone
ERP	Effective rate of protection
EU	European Union
FDI	Foreign direct investment
FTA	Free trade agreement
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GST	Goods and services tax
HS	Harmonized System
IT	Information technology
JUSFTA	Jordan-US FTA
LDC	Least developed countries
MFA	Multi-Fiber Arrangement
MFN	Most favored nation
MIT	Ministry of Industry and Trade
NRP	Nominal rate of protection
NTB	Not-tariff barriers
NAMA	Non-Agricultural Market Access
QIZ	Qualifying industrial zone
ROO	Rules of origin
STD	Special and differential treatment
UAE	United Arab Emirates
USTR	United States Trade Representative
WTO	World Trade Organization

Abstract

The objective of this report is to assist the Ministry of Industry and Trade (MIT) of the Government of Jordan in developing a strategy for the ongoing non-agricultural market access (NAMA) negotiations being undertaken as part of the Doha Development Round (DDR) of the WTO. Analysis undertaken as part of this consultancy focused on the current and expected tariff structures given WTO commitments, and also discussed the tariff peaks and escalation that characterize Jordan's tariff structure. Specific recommendations are offered on how to integrate a NAMA strategy in upcoming negotiations.

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Executive Summary

Background

The objective of this report is to assist the Ministry of Industry and Trade (MIT) of the Government of Jordan in developing a strategy for the ongoing non-agricultural market access (NAMA) negotiations being undertaken as part of the Doha Development Round (DDR) of the WTO. As part of its broader reform program, during the last ten years Jordan has been able to make a number of far-reaching changes in the trade policy regime. Key steps have been the facility granted in 1994 by the United States to allow exports produced in Qualifying Industrial Zones (QIZs), the signing of the Jordan-European Union Association Agreement in 1997, WTO accession in 2000, and the signing of the Jordan-United States Free Trade Agreement in 2001.

In today's world increasingly characterized by regional and bilateral trade agreements in addition to the ongoing WTO multilateral process in the form of the Doha Development Round (DDR), it is a major challenge attempting to maintain some degree of consistency and between the various agreements. The danger of course is that a myriad of different tariff rates, rules of origin, and other details will impose unintended additional costs on those seeking to gain greater access to partners' markets.

In examining the options available to Jordan under the NAMA negotiations, Jordan's current tariff structure and WTO commitments were reviewed. It was found that:

- The main top rate was reduced from 50 to 30 percent and the incidence of specific rates was greatly reduced. The current (2004) applied tariff rate structure for non-agricultural goods, HS chapters 25 through 97 as defined under the NAMA negotiations, is comprised of 15 *ad valorem* tariff bands plus six lines with specific tariff rates. However, many of these bands include only small numbers of lines. Most rates fall into only five bands: 0, 5, 10, 20, and 30 percent.

- Jordan's tariff structure is characterized as escalating (or cascading), which entails higher tariff rates being applied to finished goods and lesser rates to intermediate goods and raw materials. This approach, usually reflecting an industrial development strategy based on import substitution, has a number of important implications for the economy.

Negotiations on tariffs under the WTO, including the NAMA negotiations, are on the basis of bound tariff rates. In the past some countries either limited the coverage of their tariff bindings or set ceiling rates far above their applied rates making them essentially irrelevant. As part of conditions of Jordan's recent accession to the WTO, the coverage of tariff bindings is 100 percent and the rates at which tariffs are bound are generally relatively close to existing applied rates. Jordan's accession agreement entails a phased reduction of bound rates that will be completed in 2010. It is clear that by 2010 the structure of tariff bindings will be will be lower on average and there will be less variation. The share of bound tariff rates 30 percent or higher will fall by more than half. The shares of the zero and 20 percent bands increase substantially.

A comparison was undertaken of the distribution of existing applied tariff rates with the 2010 distribution of bound rates, which will most likely be the basis for any reductions agreed under the NAMA negotiations. Perhaps the most dramatic difference is the relatively large share of zero tariffs, nearly one-half, of currently applied tariff rates. Even when the accession commitments are fully implemented in 2010, only 8.2 percent of lines will be bound at zero. Clearly, a substantial number of the lines now at zero, roughly 1,000 lines, will be bound at 5 percent, leaving some scope for increasing MFN tariff rates at a later date.

Defining the Position of Jordan

It is important to briefly focus on the country's objectives to be achieved through this process. If the primary goal of policy makers is to pursue a trade policy that will provide maximum support for employment generation and economic growth generally, then there is little question that the appropriate strategy for the NAMA negotiations would be to reinforce Jordan's current commitment to an open trade environment. A progressively less restrictive trade environment has been closely aligned with other reforms that have helped overcome the financial and exchange rate difficulties a decade ago and foster a climate for increased economic growth.

It has been suggested that there may be an advantage to retaining higher MFN tariff rates in order to provide a degree of protection from imports from China and other low-cost producers. Ordinarily the motive for this type of action would be to protect domestic producers of competing goods in the home market. In the current context, in light of the move towards greater trade openness built upon existing commitments, any protection that could be provided would be limited by the extent that there is any price differential on imports from the United States, European Union, Singapore, *et al.* relative imports from China.

It has also been suggested that there may be a need to protect Jordan's consumers from an inflow of inexpensive and low quality goods that might increase due to lower tariff MFN barriers. Some have argued that already there are such goods entering the market from China and other Asian producers. This sort of argument is sometimes based on the view that a country's "scarce" foreign exchange reserves should not be squandered on such goods. There are (at least) two flaws with this position. The first and most fundamental is that it reflects a view that it is the government rather than markets that would be playing a significant role in allocating domestic resources. This would appear to be inconsistent with the direction of the government's policy reforms of recent years. Secondly, it presumes that consumers should not have the opportunity to purchase inexpensive goods that might be of low quality. Most consumers, particularly those with low incomes, often find it preferable to have the option to purchase inexpensive goods when more expensive substitutes would be beyond their reach.

In summary, the economic arguments would all seem to point in the same direction – Jordan's interests would be best served in the NAMA negotiations under the DDR if this process were to be used to reinforce the country's commitment to expanding and strengthening the existing move towards a more open trading system. While it will be seen in the discussion that follows that the NAMA-WTO process would readily permit or even encourage a deviation from the direction the country has been pursuing, the

economics are clear that succumbing such a diversion would inevitably be counterproductive.

Recommendations

1. Establish National Economic Priorities

The government should be clear in stating its economic priorities. Based on earlier statements, it seems quite clear that increasing economic growth and the process of economic development are Jordan's primary economic objectives. Poverty can only be reduced if there are more and better employment opportunities available. Real incomes will increase only if there is a sustained increased in the demand for labor. This requires sustained growth.

2. Establish Comprehensive National Trade Policy

The government should establish a comprehensive national trade policy, making clear how the various elements such as the WTO process, regional and bilateral FTAs and the fit within this broader framework. It is argued in this report that these should be seen as transitional measures to be used in developing a consistent, stable open trade regime. The different elements of the national trade policy should be clearly linked to achieving the broader national economic objectives mentioned above.

There is a danger with the WTO negotiating process of holding back tariff reductions in the hope that this can be used as leverage to induce other countries to offer increased market access. Many countries play this game with the result that many maintain higher tariff rates than suit their national self-interest. For Jordan, a small country, there is little to gain with such a strategy.

3. Pay Greater Attention on Trade Facilitation

As the FTAs come to play a larger role, they bring with them a number of important trade facilitation challenges. Perhaps the most potentially troublesome are the requirements for documenting compliance with the rules of origin (ROO). This process typically entails issuance of certification by a national authority that the ROO have been met. There is much that can be done to reduce the time required and other administrative burdens in this process.

4. Adopt a Position in the NAMA Negotiations

This should not be addressed in isolation but seen as an integral part of the national trade policy framework. If, as argued here, to goal is to reduce MFN tariffs in line with reductions to be undertaken as part of existing FTAs, then the position ought to be to avoid seeking special exemptions, even if they may be available, (e.g., as a newly acceded member).

Aditional commitments to reduce tariffs under the DDR should begin after the implementation of the commitments undertaken as part of accession is completed. Given what appears at this stage to be the shape of the likely outcome of the NAMA negotiations, this would still provide a relatively long timeframe within which to reduce

tariff rates. Of course, nothing agreed under these negotiations will preclude Jordan from reducing tariff rates more rapidly.

5. Consider a Sectoral Tariff Component

The potential for sectoral tariff agreements, whether voluntary or not, raises issues of concern regarding the erosion of preferences under existing preferential agreements, such as FTAs. A possible sectoral agreement on textiles and clothing in particular would undermine the preferential access to the United States that Jordan now enjoys. Most of the other sectors that have been mentioned hold out the potential for some gain for Jordan, including electronics and electrical goods; fish and fish products; footwear and leather goods; motor vehicle parts and components; and stones, gems and precious metals.

While it *may* be the case that a sectoral agreement covering textiles and clothing would not be in Jordan's immediate interest, it should be recognized that the value of the existing preferences is likely to be eroded in other ways outside of the WTO process. Most of the countries adversely affected by the end of the MFA quota regime are seeking means to alleviate these consequences. The evolving nature of global trade preferences reinforces the arguments made above, that FTAs and other similar arrangements should be viewed as transitional steps towards adoption of a permanent open trade environment. The United States, European Union, Japan and other major markets can be expected to continue to enter into preferential agreements with other countries which will also erode Jordan's existing preferences.

In light of these changes, it is likely that sectoral agreements under the DDR which would increase Jordan's access to markets globally would be in the country's economic interests. Simply put, if the major markets where Jordan now has preferential access are to be gradually opened to more potential competitors in any case, increased access to smaller markets through sectoral agreements would be a potential gain.

6. Revenues from Trade Taxes

A reliance on revenues from tariffs and other forms of taxation on trade has long been seen as an impediment to comprehensive trade reform in many countries. The potential loss of revenue is certainly an issue of concern for the Jordanian government. Regardless of the outcome of the DDR, it is inevitable that revenues from import taxes will continue to decline significantly. More than 70 percent of current imports come from countries where there are trade agreements now in place (United States, European Union, Singapore) or are being put in place (the Middle East). As tariff reductions for imports from these sources are implemented, it is to be expected that the share of goods coming from these countries will only increase. It is impossible to make a precise estimate as sufficiently detailed data are not available, but based on very rough measures, it would not be surprising if the share of imports from countries with preferential trade agreements were to increase to 80 percent or more. Some degree of substitution towards imports subject to preferential rates would take place as long as existing higher tariffs remained in place for imports from countries without preferences. It should be kept in mind that MFN duties are also being reduced as part of Jordan's WTO accession commitments, which would of course reduce substitution in this way.

Policy makers should consider at what point the costs incurred in collecting these rapidly diminishing revenues outweigh the benefits of the revenues received. These costs include both the direct administrative costs as well as the indirect economic costs incurred by importers. If some imports are to continue to be taxed, the government should consider moving towards a uniform rate of duty. This is an approach followed by a number of countries; perhaps the most well known example is Chile, where there is a single rate of 4 percent that applies to all non-preferential imports. This greatly reduces the economic costs resulting from distorted incentives leading to the misallocation of resources.

1. Introduction

As a small, lower-middle income developing country with severe natural resource constraints, Jordan's economic growth and development depends crucially on expanding international trade. To do this requires maintaining a consistent and credible trade policy that will establish Jordan as a profitable platform for investment in activities that can respond competitively to opportunities in overseas markets. Trade policies have impacts on virtually every aspect of the domestic economic environment, sending direct and indirect signals to markets through their effects on local prices and the costs of doing business. If the country is to realize the broader economic benefits available through a more open trade regime, it is essential to ensure that all of the elements of trade policy are sending consistent signals.

The multilateral World Trade Organization (WTO) process is only one of a number of elements of trade policy that must be addressed by the government. Others include internal commercial laws, regulations and procedures as well as bilateral and regional trade agreements. The primary strength of the WTO system is that it establishes a broadly consistent set of rules for the conduct of international trade.[1] These rules can be especially helpful for small countries with limited economic power seeking equal access to the larger markets of the world. As a newly acceded member to the WTO, Jordan would seem to have benefited considerably through the accession process that has entailed a thorough review of trade related regulations and procedures leading to a number of reforms currently being implemented.

The primary goal of the exercise at hand is to assist the Ministry of Industry and Trade (MIT) of the Government of Jordan with the development of a strategy for the country for the ongoing non-agricultural market access (NAMA) negotiations being undertaken as part of the Doha Development Round (DDR) of the WTO.[2] While the principal focus is on only one part of the DDR, which is itself only one part of Jordan's larger trade policy framework, the strategy adopted should be consistent with the other elements of the country's broader trade policy framework and its economic goals. It makes little sense to attempt to develop an appropriate strategy for the NAMA negotiations in isolation.

Recognizing the need to embed a NAMA strategy in Jordan's broader trade policy framework, this report is structured as follows:

- The next section examines a number of the broader issues that set the context in which the ongoing DDR negotiations are taking place. A particular concern is the link between trade policy reform and investment and economic growth.

- Section 3 examines the country's economic goals and constraints and the broader trade policy framework. Based on this identification it seeks to identify the nature of Jordan's interests in the DDR.

[1] It is always important to keep in mind that the WTO first and foremost a rules-based organization, and is not necessarily an organization promoting more liberal trade.

[2] The NAMA negotiations are concerned with what is usually thought of as trade in goods, excluding agriculture and defined as the tariff lines included in chapters 25 through 97 of the Harmonized System (HS) tariff nomenclature. This *excludes*, for example, most types of processed foods, tobacco, alcohol and a number of agro-based products.

- Section 4 provides an overview of the general issues arising as part of the NAMA negotiations.

- Sections 5, 6 and 7 look in greater detail at the NAMA-related issues of tariff peaks and tariff escalation, sectoral initiatives, and Jordan's role as a newly acceded member of the WTO.

- Section 8 examines ways in which a NAMA strategy should be integrated within the broader trade policy framework and, in particular, Jordan's existing bilateral trade agreements.

- Section 9 examines the ongoing process of liberalizing trade and the potential impacts on some of the "sensitive" sectors.

- Section 10 attempts to pull together the previous discussion and identifies specific recommendations.

- Section 11 briefly discusses several areas where further work is warranted.

2. Trade, Investment, and Economic Growth

"Openness to international trade accelerates development: this is one of the most widely held beliefs in the economics profession, one of the few things on which Nobel prize winners of both the left and the right agree. ….. so that it is reasonable to speak of trade openness accelerating growth, rather than leading to a sudden one-time adjustment in real income." David Dollar and Art Kraay [2004][3]

One of the main themes that run throughout this report is the fundamental importance of consistency between broader trade policies and achieving broader economic objectives. Trade policy is a tool to be used. But the ultimate goal is not trade for its own sake, but the economic growth and development that trade helps to foster.

2.1 Trade as the Engine of Growth

An enormous number of books and articles have been published examining the relationship between trade policy and economic growth and development. Much of this work began with a number of country level-studies focusing on the trade liberalization in developing countries during the 1960s and 1970s.[4] More recently there have been series of "global" studies that have shown that countries with more open trade policy regimes have tended to grow faster.[5]

Reducing trade barriers accelerates economic growth in a number of ways. First, it tends to improve the productivity in the ways that domestic resources are employed – human, physical, and financial. It does this by removing distortions in prices that arise as a result of tariffs and other trade restrictions. A good illustration of the systematic nature of these types of growth inhibiting effects is discussed in Section 6 which looks at tariff escalation and in an accompanying paper in Annex B of this report. (Tariff escalation takes place when the tariff rates on final goods are higher than the rates for raw materials and intermediate goods – such as exists in Jordan.) There it shows the tendency for an escalating tariff rate structure to give higher incentives to low value added activities while giving lower incentives (or disincentives) to high value added activities. The result is generally lower overall productivity and lower growth.

A second way that reducing trade barriers work to stimulate growth is by providing a stronger environment for investment. Increased investment has not only a direct impact on economic growth, but also can lead to increased productivity growth through technology transfer. For many developing countries the "investment effect" is the most immediate and significant economic impact of trade reform.

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[3] From "Trade, Growth and Poverty", David Dollar and Art Kraay, *The Economic Journal*, 2004.

[4] For example, see Bela Balassa and Associates, *The Structure of Protection in Developing Countries*, the Johns Hopkins University Press, 1971, and *Development Strategies in Semi-Industrial Economies*, The Johns Hopkins University Press, 1982; the series of NBER studies led by Jagdish Bhagwati and Anne Krueger, (*Anatomy and Consequences of Exchange Control Regimes*, NBER, Jagdish Bhagwati, 1978; *Economic Liberalization in Developing Countries* edited by Armeane Choksi and D. Papageorgio.

[5] For example, see Dollar and Kraay, Ibid.; Jeffrey Sachs and Andrew Warner "Economic Reforms and the Process of Global Integration", *Brookings Papers*, 1995; and for a somewhat skeptical view see Rodriguez and Rodrik, "Trade Policy and Economic Growth: A Skeptic's Guide to Cross National Experience" CEPR, London, 1999.

And like the relationship between trade reform and economic growth, there has been much study over the years of the intermediate relationship between trade reform and increased investment, especially foreign direct investment (FDI). To appreciate the importance of the trade policy environment for potential investors, one can draw a distinction between two types of investors. One type is looking to come to a country in order to produce goods for the domestic market. The other type is looking to invest in a country as base for producing entirely (or largely) for export. These investors are looking to gain from advantages such as low wage rates, human resources, or a strategic location.

Foreign investors seeking to produce for the local market are often looking for high trade barriers that will limit competition and keep prices high. For example, there are several large international producers of health and beauty consumer products that invest in developing countries to take advantage of high levels of protection. There is usually little value added locally in these firms. Consequently, there is usually little or no net economic benefit for the country. For a small country such as Jordan, the scope is very limited for attracting this type of investment. And such investment would not contribute substantially to economic growth if it were to take place.

Investors attracted to Jordan to manufacture for export offers much greater economic benefits. This is an approach taken by a number of very small but highly successful economies such as Singapore, Hong Kong and within the Middle East the United Arab Emirates (UAE). Investment in services has also played a major role in the success of these economies. Of course the garment industry provides an example of such an investor in Jordan. Although there is relatively low value added in garment production, Jordan's favorable trade position has led to it becoming a major employer, albeit of relatively low wage labor. But the garment industry is footloose, capable of rapidly relocating to other countries if better conditions can be found. This is especially true after the end of the Multi-Fiber Arrangement (MFA) quota regime.[6] The sustained economic success of export strategies in the countries in Southeast Asia has been built largely on investment in industries that entail higher levels of value added and are much less footloose industries (e.g., electronics and increasingly knowledge-intensive industries such as information technology).

Investors in production for export favor an open trading environment, with few impediments to moving goods across borders. One of the realities of doing business in an increasingly globalized world is that producers must respond ever more quickly to market demands. In complex and highly-regulated trade regimes this is impossible to do. The mere presence of tariffs and other charges that apply to goods destined to the domestic market nevertheless impose costs on exporters, even though they may be exempt. At the very least this process slows down the process of moving goods through the port. If outside of an export processing zone (EPZ), the administrative procedures required to gain exemption from import charges or to reclaim duties that have been paid require time and inevitably add to costs of doing business. It is not surprising that the three countries highly successful in attracting export-oriented investment mentioned above (Singapore,

[6] It may be worth noting that there are a number of initiatives currently underway in the United States and Europe to restore some of the benefits lost with the quota system to a number of least developing countries, especially in Africa, and countries affected by the recent Asian tsunami. These have the potential to eat into Jordan's current privileged position. It is likely that in coming years the competition among developing countries for investment in the garment industry will increase and conditions will remain unstable.

Hong Kong, and UAE) all have free trade policies. Other countries that are similarly successful, such as some of the countries in the Association of Southeast Asian Nations (ASEAN) and Chile in South America, have been moving in the same general direction with their trade policies.

It is worth noting briefly that while EPZs may offer a step towards a freer trade environment, they have not proven to be a sustainable alternative to general trade reform. When the costs of providing the necessary infrastructure for an EPZ are taken into account, they are often found not to yield net economic benefits to the country.[7] It is also often difficult to maintain two tax and trade regimes within the country without local producers demanding comparable treatment. (This has been the case in Sri Lanka, for example.) Pressures inevitably arise sooner or later to reduce the differential treatment of EPZ and non-EPZ enterprises. In the end, if a free trade and low tax regime make good economic sense for one part of the country, it also makes good sense for the entire country.

Finally, it has been argued that one of the principal factors underlying the potential for significant trade liberalization to generate increased investment is the credibility of the reforms.[8] There are many developing countries that have begun trade reform programs only to slow down or change course entirely. All investors need to be assured that there will be no unexpected changes in the policy environment, especially those that must make a considerable long term commitment to doing business in a country. Even relatively minor reversals can have major impacts on profitability. Therefore, investors are much more likely to locate in countries where there is a clear and firm commitment to a stable open trade regime.

This issue relates directly to the focus of this report. Through its existing and prospective free trade agreements, Jordan is signaling a commitment to move towards a free trade regime in the coming years. No doubt this is increasing interest among potential investors. However, by adopting a different stance with respect to the ongoing WTO negotiations, the commitment to such an outcome can be questioned. Free trade agreements (FTAs), like EPZs, offer a potentially useful stepping stone towards adoption of an economically sound open trade regime. But like EPZs, FTAs can have hidden administrative and procedural costs (e.g., documentation requirements and rules of origin). They rarely provide a lasting or effective alternative to more general liberalization.[9] In the current context, it would make a great deal of sense for Jordan to "lock in" the commitment to move towards a free trade regime embodied in its FTAs with an equally strong and unambiguous position with respect to the WTO negotiations underway.

[7] See, for example, Peter Warr's papers.

[8] See, for example, Bond, Chiu and Estache, 1995. "Trade Reform Designs as a Signal to Investors: Lessons for Economies in Transition", World Bank Policy Research Working Paper.

[9] See Jagdish Bhagwati and Arvind Panagariya, who argue that FTAs and regional trading arrangements can be counterproductive when they distract from more general trade policy reform: "The Theory of Preferential Trade Agreements: Historical Evolution and Current Trends", *American Economic Review*, 1996, as well as papers in *Trading Blocs: Alternative Approaches to Analyzing Preferential Trade Agreements*, Bhagwati, Krishna and Panagariya (eds), MIT Press, 1999.

2.2 Trade in Services

It is easy to overlook in considering these issues the fact that by far the largest sector in the Jordan's economy is services, which accounts for 72 percent of gross domestic product (GDP). As barriers to the trade in services are being reduced globally, more and more countries are finding that this area offers enormous opportunities for expanding skilled employment and increasing incomes. For example, the rapid growth of information technology (IT) and "back office" services has been one of the driving forces behind strong growth of India in recent years. Indeed, investment aimed at increasing tourism and medical services for foreigners has been identified as potentially attractive investments in Jordan.

The profitability of service providers depends upon the costs of local human resources; it also is sensitive to the costs for material inputs, including buildings, equipment, and other materials. If local prices are high relative to international prices due to trade barriers, the cost of providing services will be higher, reflecting these added costs. And naturally this tends to undermine the ability of Jordanian service providers to compete effectively.

3. Identifying Jordan's Interests in the Doha Round

3.1 Economic Goals and Constraints

For Jordan, like most other developing countries, a central focus of economic development is the elimination of poverty and improved economic welfare generally. As experience gained in many countries has amply demonstrated, a necessary condition for these conditions is the rapid and sustained increase in job creation. This will not only provide jobs for those currently unemployed, but by increasing the aggregate demand for labor will create the conditions necessary to increased incomes generally.

One indication of the importance with which these goals is viewed comes from the annual public opinion poll conducted by the *Center for Strategic Studies* at the University of Jordan. Survey results indicated that by far the highest national priority amongst those surveyed was addressing unemployment and poverty (52 percent of those surveyed).[10]

All countries, developed and developing, have at the center of their economic objectives providing more and better employment as a means for increasing the incomes of their people. This is necessary not only to fulfill the aspirations of their people, but also generate sufficient national income to undertake required investments in social and economic infrastructure. Closer regional and global economic integration also provides a stronger foundation for maintaining peace as well as prosperity. Nowhere are the potential social and political benefits of closer economic ties likely to be greater than in the Middle East.

3.2 Jordan's Changing Economic Environment

Jordan represents a notable success in the effectiveness with which it responded to a series of exchange rate and financial crises in the early 1990s, substantially transforming the country's economic environment. This was accomplished by pursuing major policy reforms in a number of areas:[11]

- Increased macroeconomic stability;
- Trade liberalization and elimination of many price controls;
- Fiscal consolidation to reduce public debt; and
- Privatization of state-owned enterprises.

These are the typical elements that make up most reform programs and all have the common objective of ensuring that market forces play increasingly greater (more economically efficient) roles in the allocation of resources. Higher rates of economic growth can only be realized through increased investment and improved productivity in the utilization of available resources. Jordan's economic performance during the last decade demonstrates (again) the basic soundness of this approach.

[10] Reported in *The Jordan Times*, 21 October 2004. The other priorities identified included corruption (27 percent), the Palestinian cause (17 percent), enhancing democracy and freedom of expression (3.2 percent,) and the Iraqi issue (0.9 percent).

[11] See the recent 2004 International Monetary Fund (IMF) report, "Selected Issues and Statistical Appendix".

At the center of this strategy has been addressing the need to reduce the excessive public debt from more than 150 percent of GDP in 1992, which is currently estimated to be 101.5 percent of GDP. As the IMF stated in a recent report, *"Economic growth, aided by a policy of prudent debt management and privatization was the most important factor in addressing the challenge of debt sustainability."* Trade liberalization has led to major increases in exports and has played a major role in generating the growth that is permitting Jordan to grow out from under this massive debt burden. It is in this context that trade policies generally and the opportunities presented from the Doha Round more specifically should be assessed.

These fundamental changes were achieved in a relatively short period of time, less than a decade, and have yielded significant positive economic results. However, it is also clear that a number of important challenges still must be addressed if Jordan is to be able to consolidate and extend the gains that have been achieved.

By the World Bank's definition, Jordan is still a small, lower middle income developing country.[12] It faces relatively severe natural resource constraints as well as major geo-political challenges, leaving it vulnerable to external shocks. Gross per capita national income in 2003 was $1,850, reflecting only moderate average growth since 1990 of 4 percent. Approximately 11 percent of the population of 5.3 million falls below the poverty line – most of whom have incomes of no more than $2 a day. The agricultural sector is very small, only 2 percent of GDP. The industry sector accounts for 26 percent of GDP (of which mining is about 3 percent); the largest sector is services, accounting for 72 percent. Inflation has remained consistently low; the average growth in the GDP deflator was only 2.6 percent between 1990 and 2003. Government does not absorb an excessive share of the country's resources – 23 percent of GDP.

Jordan has put in place a relatively good climate for private investment, especially when compared with other lower middle income developing countries. Indicators reported in the current World Bank *World Development Report* such as days required to start and register a business or resolve insolvency are all better than average. The index intended to reflect the overall risk associated with the investment climate is also substantially better than the average.

3.3 The Trade Policy Framework

Trade policy plays a major role in defining a country's economic environment, working through price signals and influencing the ways in which resources are utilized. As such it is one of the most powerful tools available to policy makers and typically is the foundation for industrial and agricultural sectoral policies. But to be effective it must be applied in ways that are closely aligned with the country's core economic objectives – increasing economic growth, generating employment and higher incomes.

It is equally important that the different elements of trade policy are used in consistent ways – pulling in the same direction, not working at cross purposes. In Jordan this is largely the responsibility of the officials in the Ministry of Industry and Trade to monitor the design and implementation of trade policies to ensure that these critical conditions are

[12] See A Better Investment Climate for Everyone" the World Bank's *World Development Report*, 2005.

being met. However, as in all countries, trade policy cuts across a number of areas and different agencies are inevitably engaged in the formulation of trade policies.[13]

3.3.1 Bilateral and Regional Trade Agreements

As part of its broader reform program, during the last ten years Jordan has been able to make a number of far-reaching changes in the trade policy regime. Many of these have only been possible due to the unique geo-political role that Jordan plays. Key steps have been:

- The facility granted in 1994 by the United States to allow exports produced in *Qualifying Industrial Zones* (QIZs), providing the only exception (so far) to the long-standing prohibition on preferential treatment of imports to the United States produced in export processing zones. The QIZs are subject to rules of origin that require mutual value added targets be met by Israel and Jordan. Despite these complex requirements, the QIZs have been responsible for a large part of the export boom that has been taking place in recent years. (Discussions have been underway to extend QIZs to cover joint Egyptian-Israeli production as well, but these talks are currently delayed.[14])

- *The Jordan-European Union Association Agreement*, signed on 24 November 1997 and that is leading to the elimination of tariffs and other barriers to trade by 2014. Note that this agreement goes beyond liberalizing the trade in goods, but these other provisions, including reducing barriers to investment and the trade in services, are not addressed here as they are outside the scope of this report.

- Accession into the WTO in 2000. Jordan's accession agreement has almost certainly spurred considerable needed trade policy reforms, beyond the agreed phased (10 year) reduction in tariff rates. The top *bound* tariff rates are scheduled to be reduced from 30 to 20 percent.

- The signing of the *Jordan-United States Free Trade Agreement* (JUSFTA) in 2001 whose main feature is the progressive elimination of tariffs and other trade barriers by 2010 for virtually all goods. (See Annex A for more details on the schedule of tariff reductions.) Note that this agreement goes beyond liberalizing trade in goods; however, these other provisions, including those on reducing barriers to investment and trade in services, are not addressed here as they are outside the scope of this report.

[13] Although outside of the scope of this exercise, it is worth suggesting that the government consider the institutional structure used for the three principal functions of trade policy: design, negotiation and promotion. In many countries, in addition to the trade ministry, the ministries of finance, planning, foreign affairs and sectoral ministries for agriculture and industries typically play important roles. Of course in Jordan, one ministry has responsibility for both trade and industry – which could lead to conflicting policy perspectives. While far from perfect, the US model centered on the cabinet-level office of the United States Trade Representative (USTR), which is the institutional mechanism used to lead the formulation of trade polices and negotiate trade agreements, is an example of an alternative, more independent approach. Another approach adopted by Australia has been to ensure an independent agency, formerly the Industry Commission, to publicly review trade policies with an explicit economy-wide perspective.

[14] As reported in the *Financial Times* on 22 October and cited on Sandler, Travis and Rosenberg *World Trade Interactive* website (23 October).

- Jordan is also a member of the *Arab Free Trade Agreement* (AFTA). As part of this agreement, Jordan has bilateral trade agreements with Middle East and North African (MENA) countries.

- The *AGADIR Agreement* to establish a free trade agreement between Jordan, Egypt, Tunisia and Morocco is being developed. This will permit a basis for regional accumulation in meeting the rules of origin under the Jordan-EU Agreement. (See more on this below.)

- And most recently a free trade agreement with Singapore has been concluded. This agreement also aims to eliminate tariffs and other trade barriers for virtually all trade over a period of ten years.

In today's world increasingly characterized by regional and bilateral trade agreements in addition to the ongoing WTO multilateral process in the form of the Doha Development Round (DDR), it is a major challenge attempting to maintain some degree of consistency and between the various agreements. The danger of course is that a myriad of different tariff rates, rules of origin, and other details will impose unintended additional costs on those seeking to gain greater access to partners' markets.

As pointed out above, trade policies generally play a fundamental role in defining the characteristics of a country's economic environment. In an open trade regime, the range of commercial options open to both producers and consumers is greatly expanded. Local prices are typically lower and often more stable. Once trade barriers are reduced below the point where reasonably active trade can take place, domestic prices for most goods remain closely linked with prevailing world prices.

It is well known that "protection" for domestic producers operates by maintaining a differential (or wedge) between domestic and world prices. Keeping domestic prices higher than world prices allows domestic producers to charge more for their products, in effect being indirectly subsidized by higher consumer prices. (A protective tariff is equivalent to allowing producers to impose and additional sales tax on consumers directly, keeping the revenues.) Protection is intended to serve as an incentive to draw resources to a favored activity by encouraging producers to invest and expand production in these areas.[15]

In a situation with multiple bilateral trade agreements such as exist today in Jordan, the questions of incentives becomes vastly more complex. When it is possible to import a good from any one of a number of suppliers subject to different trade agreements and different tariff rates and rules of origin, it may be impossible to know *a priori* which tariff rate will be most advantageous and will be utilized. This has the potential to lead to very different and unintended signals (incentives) being given to different activities than makes good economic sense. And as different bilateral agreements are being phased in different ways, these incentives may become very unstable, changing significantly as new tariff rate reductions are being introduced.

[15] The analytic tool used to measure and assess the incentives inherent in the trade policy regime is the effective rate of protection. See the references cited below.

It is for these reasons that a high premium should be put on policy coordination when a country is a party to multiple trade agreements. There are good economic reasons to suggest that countries that are phasing down internal tariffs as part of regional or bilateral trade agreements also reduce most-favored nation (MFN) tariffs in much the same way. This is, for example, the approach more or less followed by a number of the ASEAN countries that were part of the "original six" members of the ASEAN Free Trade Agreement.[16]

3.3.2 Trade Diversion

The economic argument for avoiding substantial differentials in tariff rates is based on limiting the prospects for "trade diversion". Simply put, when it is possible to import a good from one country at a preferential tariff rate that is substantially lower than the MFN rate applying to the rest of the world, there is the prospect that imports will be diverted in favor of the country with the preferential tariff. When the good in the country with the preferential tariff is actually more costly (before the tariffs are applied) than imports from other sources, the importing country essentially wastes resources. This arises because differential tariff rates distort the calculations of importers, making the goods from the country with preferential tariff rates artificially appear to be less expensive. The greater are the differences between tariff rates applicable for the same good, the greater the scope for trade diversion to take place.

3.3.3 Rules of Origin

At this point it may be useful to make a point about some of the implications for Jordan of the rules of origin included in these agreements. Jordan is a small country with a very narrow economic base. The United States and the European Union (EU) in contrast are not only very large but have very diverse economies. It is much more likely that producers of manufactured goods in these two countries will face far fewer constraints in meeting the rules of origin to gain preferential access to Jordan's markets. These rules have the potential to be much more of a challenge for Jordanian producers who must operate from a much narrower base.

The rules of origin in the United States and the recent Singapore FTAs are for generally broad. For goods that are not "wholly originating" in Jordan (mainly agricultural and natural resource-based products) there is a requirement for goods to receive preferential treatment that 35 percent of the value of the good be comprised of local value added and originating inputs. (There are different rules for textiles and apparel.) To meet this 35 percent requirement, it is possible to use raw materials and intermediate goods originating in the partner country, e.g., Jordan may use US inputs in producing goods destined for the US market under the agreement – "bilateral accumulation" or "cumulation".

The rules of origin under the Jordan-EU agreement are much more detailed and complicated. As with the US and Singapore agreements, the Jordan-EU agreement permits bilateral accumulation in meeting the rules of origin. However, the agreement also permits diagonal accumulation among the other regional countries that are members

[16] Indonesia, Malaysia, Thailand, Singapore, the Philippines, and Brunei.

of the AGADIR Agreement (i.e., Jordan, Egypt, Morocco, and Tunisia) that have (or are negotiating) comparable trade agreements with the European Union.

One reason for raising the issue of rules of origin under bilateral trade agreements is to note the added complexity that must be overcome by Jordanian exporters if the goals of a more open trading environment are to be achieved.

3.4 Brief Review of Jordan's Tariff Rate Structure

Table 1
Distribution of Applied Non-Agricultural Tariff Rates, 2004

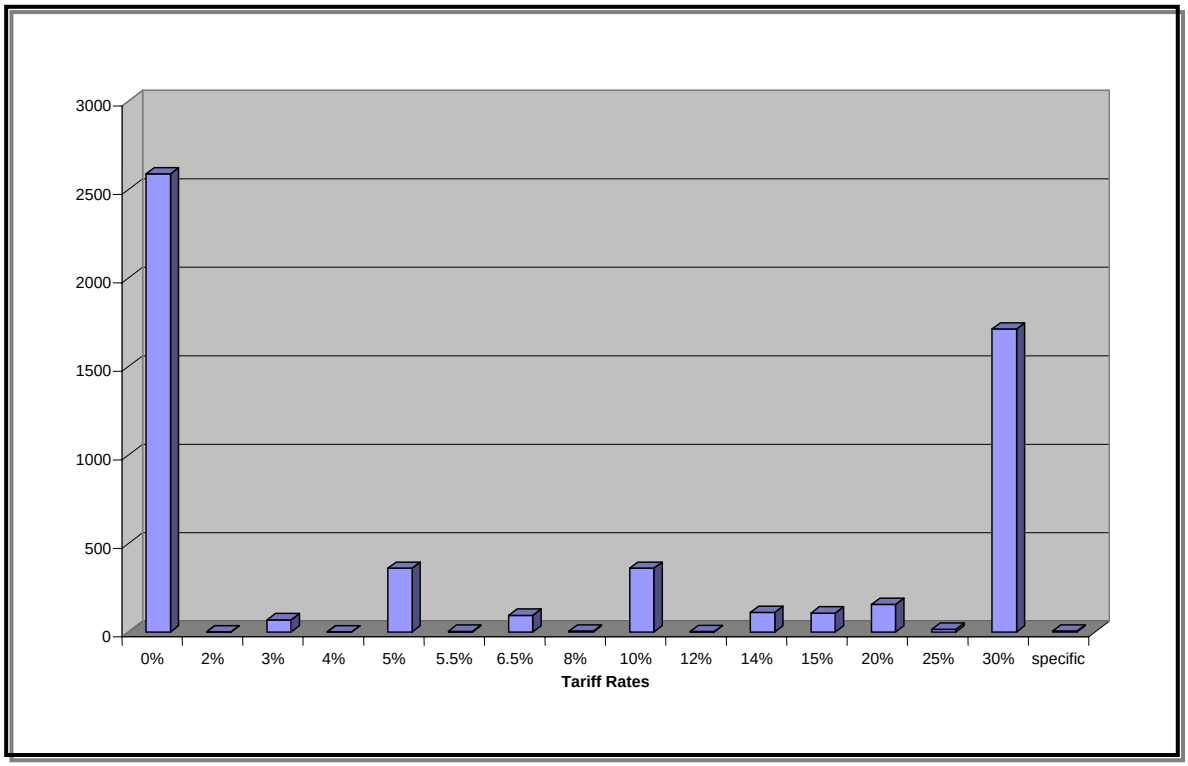
Rate (%)	Lines (No.)	Shares (%)
0	**2,590**	**46.25**
2	1	0.02
3	69	1.23
4	1	0.02
5	**361**	**6.45**
5.5	4	0.07
6.5	95	1.70
8	6	0.11
10	**361**	**6.45**
12	3	0.05
14	111	1.98
15	108	1.93
20	**156**	**2.79**
25	15	0.27
30	**1,713**	**30.59**
specific	6	0.11
Total	**5,600**	**100.00**

In examining the options available to Jordan under the NAMA negotiations, it is important to review the existing tariff rate structure and the commitments that have been made under the WTO accession agreement. The current rate structure reflects substantial reforms that have taken place over the last decade. The main top rate has been reduced from 50 percent to 30 percent and the incidence of specific rates greatly reduced.[17]

The current (2004) applied tariff rate structure for non-agricultural goods, HS chapters 25 through 97 as defined under the NAMA negotiations, is comprised of 15 *ad valorem* tariff bands plus six lines with specific tariff rates. However, many of these bands include only small numbers of lines. Most rates fall into only five bands: 0, 5, 10, 20, and 30 percent (see Table 1 and Figure 1).

[17] "Specific" tariff rates are usually expressed as an amount of money per unit, such as JD1 per kilogram. This is in contrast to ad valorem tariff rates expressed as a percentage of the cost, insurance, freight (CIF) value of an imported good.

Figure 1: Frequency of Applied Tariff Rates, by Numbers of Tariff Lines



3.4.1 Cascading/Escalating Tariff Rate Structure

An important characteristic of Jordan's approach to setting import tariffs is the escalating (or cascading) structure that it embodies. (Note that these terms are used interchangeably.) Briefly, this entails maintaining higher tariff rates for finished goods and lesser rates for intermediate goods and raw materials. This approach, usually reflecting an industrial development strategy based on import substitution, has a number of important implications for the economy. (A paper examining some of these issues in greater depth is included in Annex B. This issue is also discussed further below.)

In the existing tariff rate structure, most final goods, certainly those produced in Jordan, fall in the 30 percent tariff rate band. Most of the intermediate goods and raw materials used by these activities are subject to tariff rates of 10 percent or lower.

3.4.2 Tariff Rates Bound Under the WTO

Negotiations on tariffs under the WTO, including the NAMA negotiations, are on the basis of bound tariff rates. (A WTO member binds rates as a ceiling, above which they cannot go without the consent of other WTO members.) In the past, some countries either limited the coverage of their tariff bindings or set ceiling rates far above their applied rates making them essentially irrelevant. As part of conditions of Jordan's recent accession to the WTO, the coverage of tariff bindings is 100 percent and the rates at which tariffs are bound are generally relatively close to existing applied rates. (One of the principal goals of the DDR is for developing countries to considerably extend the coverage of their tariff bindings and to reduce the gap between bound and applied rates.)

Table 2 Comparison of Bound Tariff Rates 2000 & 2010				
	2000		2010	
Rate (%)	Lines (No.)	Shares (%)	Lines (No.)	Shares (%)
0	**220**	**3.74**	**482**	**8.20**
5	1,313	22.34	1,243	21.15
5.5	2	0.03	116	1.97
6.5	1	0.02	362	6.16
10	913	15.53	613	10.43
15	458	7.79	513	8.73
20	191	3.25	1,198	20.38
25	4	0.07	21	0.36
30	**2,726**	**46.38**	**1,328**	**22.59**
35	48	0.82	0	0.00
specific	2	0.03	2	0.03
Total	**5,878**	**100.00**	**5,878**	**100.00**

Jordan's accession agreement entails a phased reduction of bound rates that will be completed in 2010. A comparison of the distribution of bound tariff rates in 2000 and 2010 is presented in Table 2 and Figure 2. It is clear that by 2010 the structure of tariff bindings will be will be lower on average and there will be less variation. The share of bound tariff rates 30 percent or higher will fall by more than half. The shares of the zero and 20 percent bands increase substantially.

Now compare the distribution of applied tariff rates for non-agricultural products that existed in 2004 with the 2010 distribution of bound rates – which will most likely be the basis for any reductions agreed under the NAMA negotiations (see Table 3). Perhaps the most dramatic difference is the relatively large share of zero tariffs, nearly one-half, of currently applied tariff rates. Even when the accession commitments are fully implemented in 2010, only 8.2 percent of lines will be bound at zero. Clearly, a substantial number of the lines now at zero, roughly 1,000 lines, will be bound at 5 percent, leaving some scope for increasing MFN tariff rates at a later date.

Figure 2: Comparison of Bound Tariff Rates 2000 & 2010

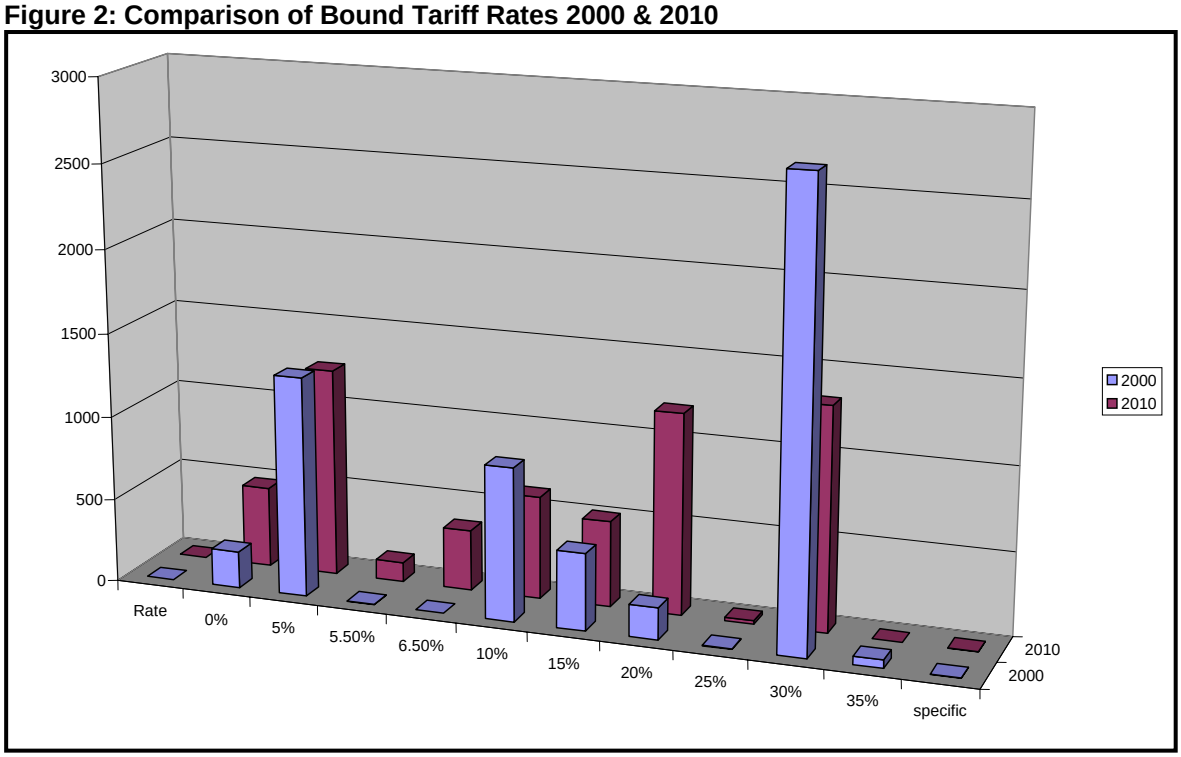
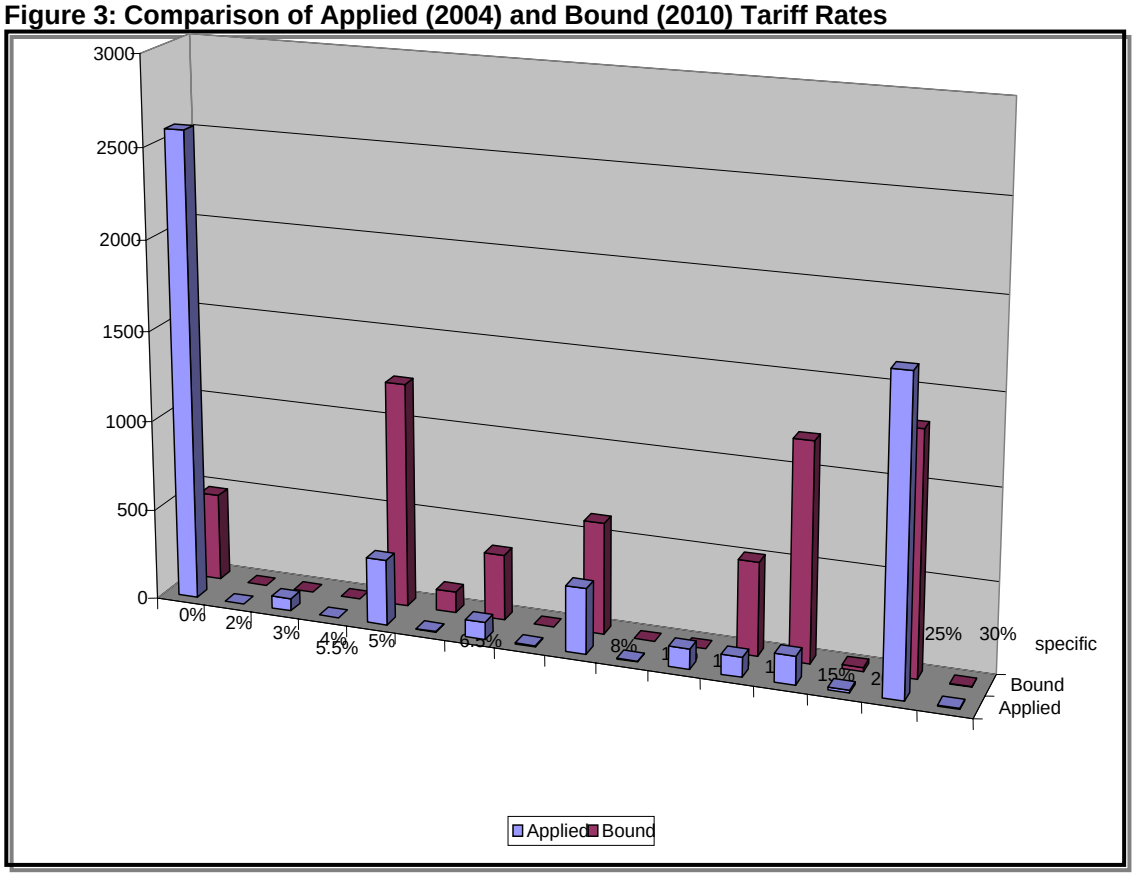


Table 3: Comparison of Non-Agricultural 2004 Applied & 2010 Bound Tariff Rates				
	2004 Applied		2010 Bound	
Rate (%)	Lines (No.)	Shares (%)	Lines (No.)	Shares (%)
0	**2,590**	**46.25**	**482**	**8.20**
2	1	0.02	0	
3	69	1.23	0	
4	1	0.02	0	
5	361	6.45	1,243	21.15
5.5	4	0.07	116	1.97
6.5	95	1.70	362	6.16
8	6	0.11	0	
10	361	6.45	613	10.43
12	3	0.05	0	0.00
14	111	1.98	513	8.73
15	108	1.93	1,198	20.38
20	156	2.79	21	0.36
25	15	0.27	1,328	22.59
30	1,713	30.59	0	0.00
Specific	6	0.11	2	0.03
Total	5,600	100.00	5,878	100.00

Figure 3: Comparison of Applied (2004) and Bound (2010) Tariff Rates



3.5 Identifying Jordan's Interests in the Doha Development Round

Before looking at the detailed issues to be addressed under the NAMA negotiations, it is important to briefly focus on the country's objectives to be achieved through this process. If the primary goal of policy makers is to pursue a trade policy that will provide maximum support for employment generation and economic growth generally, then there is little question that the appropriate strategy for the NAMA negotiations would be to reinforce Jordan's current commitment to an open trade environment. A progressively less restrictive trade environment has been closely aligned with other reforms that have helped overcome the financial and exchange rate difficulties a decade ago and foster a climate for increased economic growth.

One of the most important principles underlying the development and implementation of an effective economic policy framework is the maintenance of consistency in approach. The commitments to strengthening and expanding the environment for open trade are already embodied in the series of far reaching regional and bilateral agreements that are already in place as well as Jordan's WTO accession agreement and other related reforms. When fully implemented, these agreements together will ensure that virtually all types of goods will be able to enter Jordan subject to minimal duties and other barriers. These agreements will also encourage the removal of most important barriers to trade in services and investment. Together this will offer producers of goods and services in Jordan a strong foundation on which to increase the competitive exports of goods and services.

It has been suggested that there may be an advantage to retaining higher MFN tariff rates in order to provide a degree of protection from imports from China and other low-cost producers, (i.e., lower costs than the United States, European Union, Singapore, countries within this region, etc). Ordinarily the motive for this type of action would be to protect domestic producers of competing goods in the home market. In the current context, in light of the move towards greater trade openness built upon existing commitments, any protection that could be provided would be limited by the extent that there is any price differential on imports from the United States, European Union, Singapore, *et al.* relative imports from China.

While there may be a popular notion that China and some other Asian countries are exporting large amounts of goods below cost or at unrealistically low prices, there is little evidence to support this. (Anecdotal evidence provided by producers seeking tariff protection cannot be given much weight.) Given the small size and limited purchasing power of Jordan's domestic market, there is very little scope for promoting domestic production to any meaningful extent. This is a case where any of the expected "benefits" that would be derived by providing protection would be small and largely illusory. However, the potential costs to the economy by undermining the gains that have been achieved through the reforms undertaken in recent years could be substantial – largely because by adopting an inconsistent policy line it would undermine Jordan's commitments to an open trading system.

It has also been suggested that there may be a need to protect Jordan's consumers from an inflow of inexpensive and low quality goods that might increase due to lower tariff MFN barriers. Some have argued that already there are such goods entering the market from China and other Asian producers. This sort of argument is sometimes based on the view

that a country's "scarce" foreign exchange reserves should not be squandered on such goods. (More often this argument is based on preventing/reducing imports of high priced luxury consumer goods.) There are (at least) two flaws with this position. The first and most fundamental is that it reflects a view that it is the government rather than markets that would be playing a significant role in allocating domestic resources. This would appear to be inconsistent with the direction of the government's policy reforms of recent years. Secondly, it presumes that consumers should not have the opportunity to purchase inexpensive goods that might be of low quality. Most consumers, particularly those with low incomes, often find it preferable to have the option to purchase inexpensive goods when more expensive substitutes would be beyond their reach.

In summary, the economic arguments would all seem to point in the same direction – Jordan's interests would be best served in the NAMA negotiations under the DDR if this process were to be used to reinforce the country's commitment to expanding and strengthening the existing move towards a more open trading system. While it will be seen in the discussion that follows that the NAMA-WTO process would readily permit or even encourage a deviation from the direction the country has been pursuing, the economics are clear that succumbing such a diversion would inevitably be counterproductive.

4. Brief Overview of the NAMA Negotiations & Key Issues

The Doha Development Round was launched at the Fourth Ministerial Meetings in Qatar in November 2001. The mandate agreed in Doha was far reaching and represented an attempt to address remaining major gaps in the existing multilateral trading system (e.g., agriculture) as well as implementation issues outstanding from the earlier Uruguay Round. As its name suggests, the DDR was begun with a commitment that this round of negotiations would address the particular needs of the developing country members.

> *"International trade can play a major role in the promotion of economic development and the alleviation of poverty. We recognize the need for all our peoples to benefit from the increased opportunities and welfare gains that the multilateral trading system generates. The majority of WTO Members are developing countries. We seek to place their needs and interests at the heart of the Work Programme adopted in this Declaration."*[18]

A key element in this mandate is to continue with what has been the traditional process of reducing tariffs that limit trade in non-agricultural goods. This has been the central focus of the General Agreement on Tariffs and Trade (GATT) since its inception in 1948 and subsequently of the WTO since its inception in 1995. The broad aim of the NAMA dimension of the DDR is to reduce tariffs on all non-agricultural products, or more specifically,

> *"to reduce, or as appropriate eliminate tariffs, including the reduction or elimination of tariff peaks, high tariffs, and tariff escalation, as well as non-tariff barriers, in particular on products of export interest to developing countries".*

In keeping with the development focus of the DDR, this objective came with an important caveat: the commitment that developing and least-developed countries need not necessarily match or reciprocate in full tariff-reduction commitments by developed country members. It is also worth noting that it was recognized that Jordan was among a group of countries to have recently acceded to the WTO and the "extensive market-access commitments" that were made as a part of this process. (While this fact was recognized, its implications for commitments are left to the negotiation process.)

An important milestone in this process was the Fifth Ministerial Meeting held in Cancun, Mexico in September 2003. It was expected that an intermediate declaration would be adopted at Cancun that would embody an agreement on the way forward for the negotiations. This was not possible and subsequent meetings were required. A breakthrough of sorts was achieved on 31 July 2004 where such an agreement, the "Doha Draft Work Program", laying out the way forward was reached.[19] It is within the parameters established in this document that the Jordanian Government must build its strategy.

[18] Paragraph 2 of the Doha Ministerial Declaration, 14 November 2001. Note that all of these cited WTO documents can be obtained at the WTO web site, www.wto.org.

[19] "Doha Work Programme, Draft General Council Decision of 31 July 2004."

4.1 Current Negotiating Framework

At this point it may be useful to try to synthesize and briefly elaborate on the current negotiating framework for the NAMA talks, including the key issues that the MIT must address. Please note that a number of elements of the negotiating framework outside of the scope of this exercise are not addressed here, (e.g., non-tariff barriers, trade in environmental goods, etc.) This is based on three key documents: the Doha Declaration (November 2001), Draft Elements of Modalities for Negotiations on Non-Agricultural Products (August 2003, in preparation for Cancun) and the Doha Work Programme, Draft General Council Decision of 31 July 2004.

- In the NAMA negotiations the DDR continues to aim for an ambitious result of tariff reductions, "including the reduction or elimination of tariff peaks, high tariffs, and tariff escalation, as well as non-tariff barriers, in particular on products of export interest to developing countries."[20]

- A related objective of this round has been to move closer towards full coverage of tariff bindings. As a recently acceded member, Jordan has already bound 100 percent of its non-agricultural tariff rates.

- There continues to be a commitment to agree a formula as the basis for reducing tariffs.[21] The goal is to agree a nonlinear formula that would reduce or eliminate tariff peaks, high tariffs, and tariff escalation. At the moment it appears that the general approach would be to adopt a variation of the "Swiss Formula" to be applied on a comprehensive, line-by-line basis without *a priori* exclusions. "Credit" is to be given for autonomous tariff reductions that have been enacted since the Uruguay Round. (Whether this would also include the commitments of newly acceded members is not addressed.)

- In parallel, the framework includes the intention to identify a number of sectoral initiatives "in order to eliminate and bind all tariffs on products of particular export interest to developing and least-developed country participants." The pre-Cancun document proposed the following sectors: electronics and electrical goods, fish and fish products, footwear; leather goods, motor vehicle parts and components, stones, gems and precious metals, and textiles and clothing. But clearly much needs to be done to determine sectoral coverage as well as the approach to be followed.

- On special and differential treatment for developing countries, it is expected that they will continue to have longer implementation periods for tariff reductions. It is also expected that they will be able to apply less than the full tariff reductions implied by the formula for an as yet negotiated percentage of tariff lines and totally excluding an as yet negotiated percentage of tariff lines from reductions. Both of these provisions are expected to be limited in terms of the shares of total trade.

- The 31 July 2004 document makes even more explicit the issue of newly acceded members:

[20] Plan of 31 July.
[21] See Section 5 below, where the issue of the formula is examined in greater detail.

> *"We recognize that newly acceded Members shall have recourse to special provisions for tariff reductions in order to take into account their extensive market access commitments undertaken as part of their accession and that staged tariff reductions are still being implemented in many cases. We instruct the Negotiating Group to further elaborate on such provisions."*

- A number of developing and least developed countries have raised concerns over the loss of preferences that they enjoy through bilateral or regional agreements (i.e., non-MFN or non-reciprocal preferences). This issue is to be examined during these negotiations.

- In addition, a number of developing and least developed countries have raised concerns over the potential impact on tariff revenues resulting from tariff reductions. This issue is also to be examined during these negotiations.

Much of the remainder of this paper will examine these issues in greater detail to help in identifying the options open to the Government of Jordan. However, before looking at these issues, it is important to briefly consider the WTO process and the DDR in the context of Jordan's overall approach to trade policy.

5. The Nonlinear Formula to Reduce Tariffs

In the Tokyo Round of GATT negotiations in the 1960s an agreed mathematical formula to cut tariffs across the board was used. In the more recent Uruguay Round negotiations were based on a product by product approach. Under the DDR there is agreement in principle that a mathematical formula should be used both because a nonlinear result that reduces high tariff rates proportionately more is the goal and because it is expected to be more straightforward to negotiate a formula than having 123 countries exchanging proposals on a good by good basis. But any formula approach will likely be augmented by negotiations in some areas that are intended to go beyond the formula based cuts, (such as the sectoral initiatives). The general formula under consideration is a variation on the so-called Swiss Formula:[22]

[1] $$t_1 = \frac{B \times t_a \times t_0}{B \times t_a + t_0}$$

where,

t_1 = the final tariff rate, to be bound in *ad valorem* terms
t_0 = the base tariff rate
t_a = the average of the base tariff rates
B = coefficient with a unique value to be determined through negotiation.

As a result, an immediate issue within the NAMA negotiations is determining the parameters to be used in the formula to be used in reducing tariffs. This entails several questions: the general formula that will be used for all developed countries; and how this formula will be applied by developing countries – whether there will be different parameters or different phasing schedules.

To put this in a Jordanian context, we can begin looking at what a range of values for these parameters would mean for the tariff rate structure.

- For the base rates (t_0) the 2010 bound rates were used. This reflects one possible outcome of the negotiations, that Jordan would apply the negotiated DDR tariff reductions after it fully implements its accession commitments. There are of course other possible outcomes.

- For the average of base rates (t_a) the simple average of 2010 bound rates was used (i.e., 14.87 percent). Note that the WTO makes clear that to ensure that this process is not distorted by differences between countries' use of 9-digit national tariff classifications, the average would be based on common 6-digit HS classifications. In this case this aggregation was not done. Also note that while the 2010 average for bound rates was the lowest, it was not significantly different from the 2005 average (i.e., 15.96 percent).

[22] A number of alternatives formulae have been proposed, notably by China, the European Community, Japan, Korea, and the United States. These are elaborated in the WTO document TNMA/S3/R1A, dated 17 February 2003. As this was tabled prior to the 31 July agreement where formula [1] above was proposed,;these alternatives are not examined here.

- For the B-parameter a range of values were used between one and 50, (see Table 4 and Figure 4, below). It is clear that the lower the value of B, the greater the reduction in tariff rate levels as well as a higher proportional reduction in tariff peaks and escalation.

Figure 4: Comparison of Alternative Values of "B" in Forumla

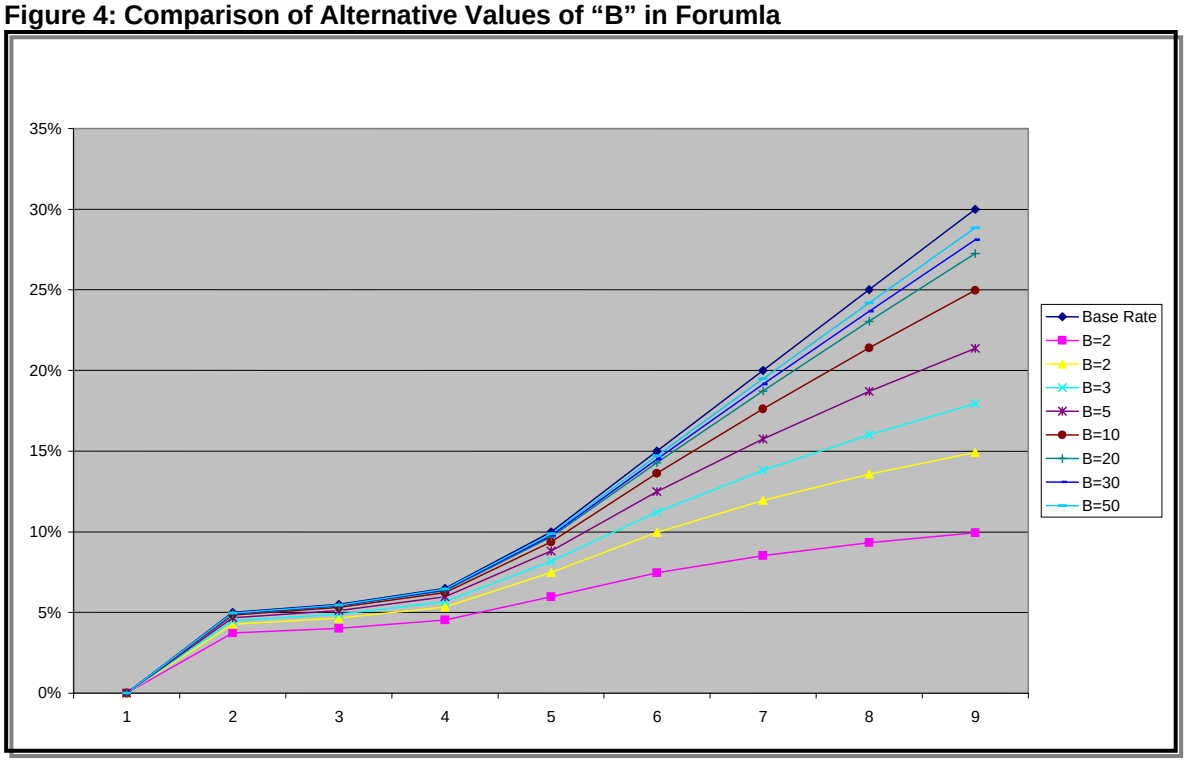


Table 4
Potential Tariff Rate Reductions Using the Formula

Base Rate	B=1	B=2	B=3	B=5	B=10	B=20	B=30	B=50
0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
5%	3.7%	4.3%	4.5%	4.7%	4.8%	4.9%	4.9%	5.0%
5.5%	4.0%	4.6%	4.9%	5.1%	5.3%	5.4%	5.4%	5.5%
6.5%	4.5%	5.3%	5.7%	6.0%	6.2%	6.4%	6.4%	6.4%
10%	6.0%	7.5%	8.2%	8.8%	9.4%	9.7%	9.8%	9.9%
15%	7.5%	10.0%	11.2%	12.5%	13.6%	14.3%	14.5%	14.7%
20%	8.5%	12.0%	13.8%	15.8%	17.6%	18.7%	19.1%	19.5%
25%	9.3%	13.6%	16.0%	18.7%	21.4%	23.1%	23.7%	24.2%
30%	9.9%	14.9%	17.9%	21.4%	25.0%	27.3%	28.1%	28.8%

Note: An average base rate of 14.87 percent was used, based upon the simple average of the bound rates for 2010. See text for further details.

6. Tariffs Peaks and Tariff Escalation

From the outset in the Doha Ministerial Declaration, the stated goal of the NAMA talks has been not only to broadly reduce tariff rates, but also to move towards more economically efficient rate structures. Thus the reduction or elimination of tariff peaks, high tariffs, and tariff escalation are all targeted in this process. These objectives have been reiterated in all subsequent statements on work program, including the "Draft Elements of Modalities for Negotiations on Non-Agricultural Products" (TN/MA/W/35/Rev 1) and more recently in the "July Package" (WT/GC/W/535, 31 July 2004).

6.1 Tariff Peaks

Before examining how the issue of tariff peaks may be addressed in the NAMA negotiations, it may be useful to consider where Jordan stands in this regard relative to other WTO members. (It should be kept in mind that we are looking here at *bound* duty rates here, which in some cases can be quite different from the applied duty rates.) There are two measures of tariff peaks being used in the NAMA negotiations:

- **International Peaks:** which are defined as the number of HS 6-digit duties higher than 15 percent, divided by the respective total number of HS subheadings. For Jordan, 46.8 percent of tariff lines exceed 15 percent.[23]
- **National Peaks:** which are defined as the number of HS 6-digit duties at least three times higher than the Member's overall simple average, divided by the respective total number of HS subheadings. Jordan's maximum tariff rate is equal to 30 percent and the simple average of HS 6-digit tariff rates is 15.2 percent. Therefore there are no national tariff peaks.

With respect to the distribution of international tariff peaks, of the 126 WTO members included in the data base, Jordan's 46.8 percent of tariff lines above 15 percent is almost precisely in the middle (59, see Figure 5 below). About one-third of members have 90 percent or more of their tariff rates above 15 percent and about 40 percent of members have rates less than 20 percent of their rates below 15 percent.

A rather different picture emerges when looking at the distribution of national tariff peaks (see Figure 6 below). A much small number of countries have any significant numbers of national (bound) tariff peaks. And the ten countries with highest shares of national tariff peaks include the major high income countries: Norway, Japan, Albania, Switzerland, United States, Iceland, European Union, Australia, Canada, New Zealand and Korea. However, if one looks at applied tariff rates, a number of these countries have no national peaks (i.e., Albania, Switzerland and Korea). But this is as much a reflection of the fact that most of these countries in fact have relatively low average applied tariff rates, (i.e., Norway, Japan, Albania, Switzerland, the United States, the European Union, and Canada all have average applied rates of 6.6 percent or less).

[23] Note, as throughout this paper, only NAMA tariff lines are being considered. This estimate is drawn from "WTO Members' Tariff Profiles" 11 September 2002 (TN/MA/S/4). This may not reflect subsequent tariff reductions being phased in, but any difference is unlikely to be significant.

Figure 5: Distribution of International Tariff Peaks Among WTO Member States

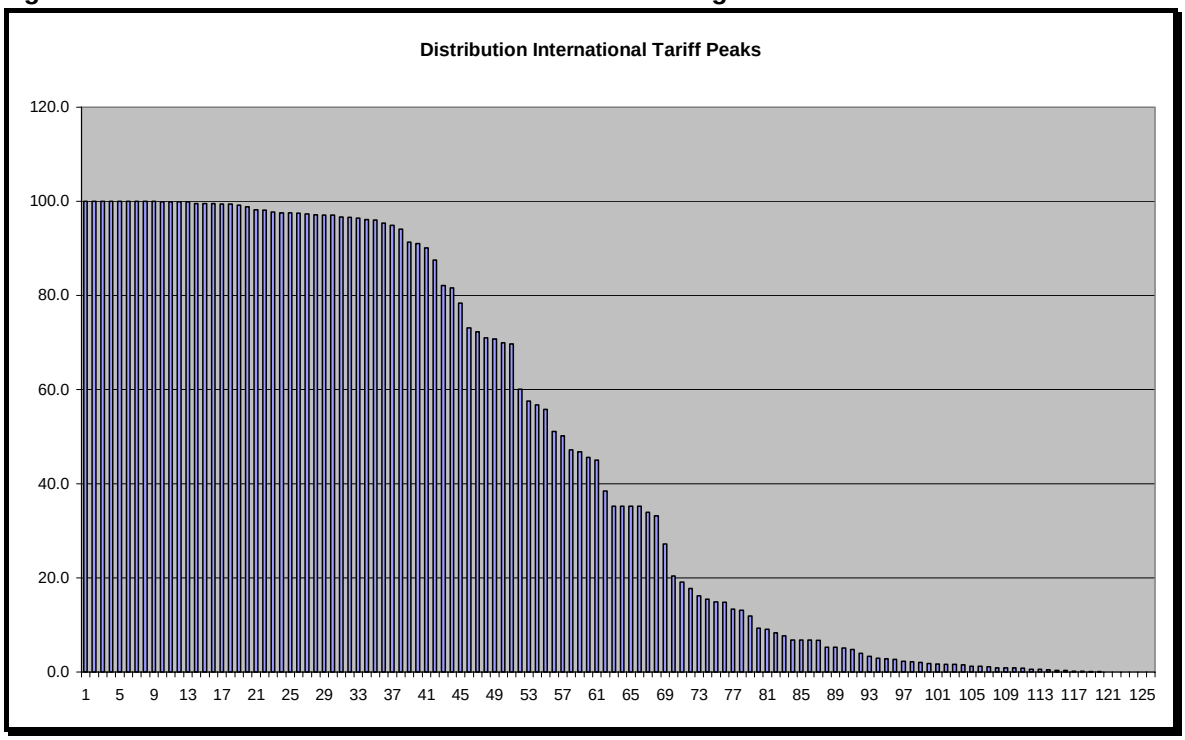
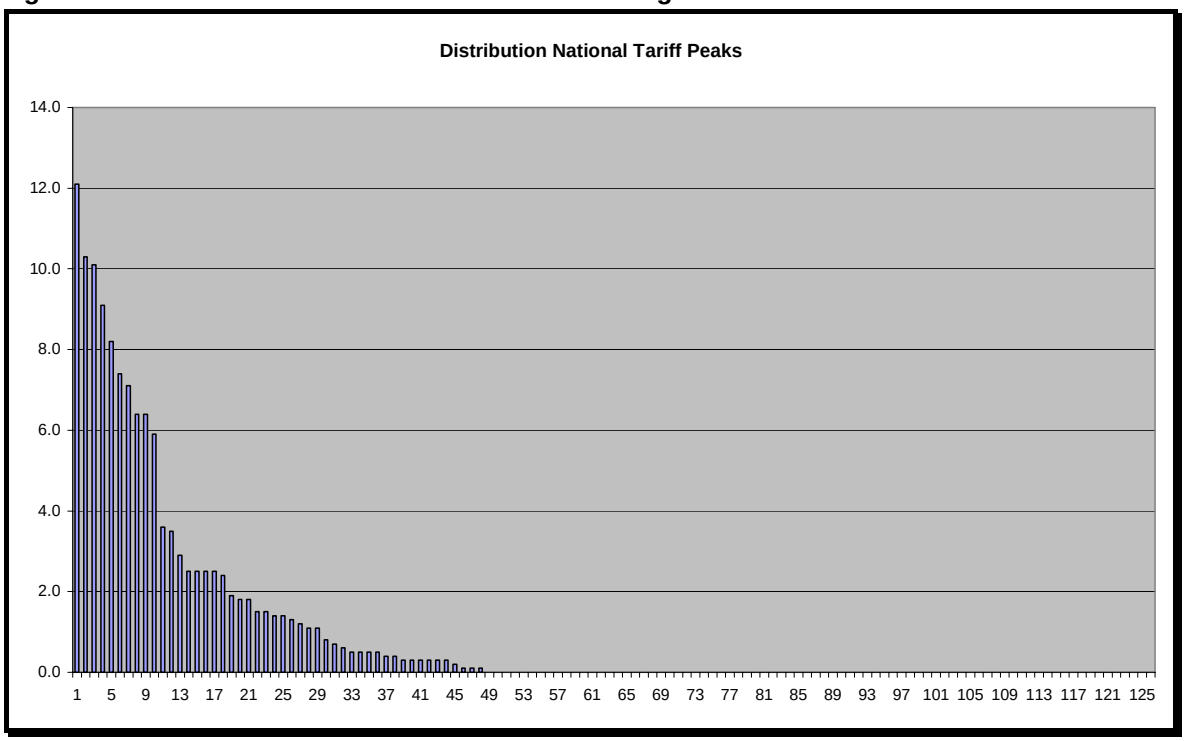


Figure 6: Distribution of National Tariff Peaks Among WTO Member States



6.2 Tariff Escalation[24]

One rationale for using a nonlinear formula for tariff reductions is to reduce tariff escalation (i.e., where there are higher import duties applied on semi-processed products than on raw materials, and higher still on finished products.) Escalating tariff rate structures emerged widely in developing countries as part of import substitution strategies during the 1960s and 1970s. The idea was that finished goods would be granted protection through higher tariffs during the initial stages. As these industries developed, the expectation was that the duties applied to intermediate goods and raw materials would be increased to provide incentives for investment in these areas. The anticipated outcome was where there would be a more or less uniform tariff and countries would be producing goods consistent with their underlying comparative advantage. Protection for selected activities was meant to be temporary and to act as a catalyst to accelerate the industrialization process.

Needless to say, this strategy failed. An inherent flaw in the approach was that in the initial stages a constituency was created that would actively resist the subsequent rounds of tariff increased for intermediate goods and raw materials. To see why and to make clearer the inherent problems with an escalating tariff rate structure it is worth briefly examining effective rates of protection.

6.3 Effective Rates of Protection[25]

The effective rate of protection (ERP) is a tool developed and first applied in the 1970s to quantify the combined impact of tariffs and other price distortions arising for trade barriers on the incentives for different activities inherent in trade policies.[26] They provide a summary measure, reflecting the additional value added that could be generated due to distorted prices. For example, an ERP of 100 percent in shoe manufacturing means that the local firms can receive as much as double the value added than would be the case if there was free trade and no tariffs or other forms of trade barriers existed. (How this artificially high value added is divided between workers and owners depends upon conditions in the labor market. The usual assumption is that most of the additional value added ends up as profits.)

Why should policy makers be concerned with ERPs? Primarily because much analysis has demonstrated that tariff rate structures that may appear to be even handed in their treatment of different types of goods usually are sending very different and often unintended signals. It is important that policy makers appreciate that their government's economic priorities may be undermined as a result of the trade policies that they have in place.

[24] Sometimes referred to as cascading tariff rate structures in the economics literature.

[25] A paper looking at the relationship between tariff rates and resulting effective rates of protection is presented in an annex to this report.

[26] The classic references on this are Bela Balassa [1971, 1982] cited above and Max Corden, *The Theory of Protection*, Oxford University Press, 1971. Much subsequent research has been done on using general equilibrium models as tools to provide more useful measures of effective protection. For example see James Anderson [1996].

Consider a simple example. Assume that there are only two tariff rates in an escalating structure: 50 percent for outputs and 35 percent for inputs. Now let us assume that the economy is comprised of only five basic industries with the following characteristics: (These assumptions are based on actual analysis carried out over the years in a number of developing countries.)

- **Simple assembly operations**, which in a situation without tariffs typically operates with very low value added produced per unit of output produced, estimated here to be on the order of 1 to 3 percent.

- **Light manufacturing**, which could include garment manufacturing using substantial amounts of imported inputs. The value added per unit of output in these types of activities is usually in the range of 5 to 20 percent.

- **Other manufacturing**, which might include activities such as furniture manufacture where components are fabricated as part of the process. Such activities have value added amounting to 20 to 30 percent of the value of the furniture produced.

- **Raw materials,** which might include cement production. The value added here is typically higher, ranging between 30 and 60 percent of the value of the output produced. And,

- **Agricultural commodities,** where the value added is always very high because the amounts of external inputs required, such as fertilizer, seeds and insecticides comprises only a small share of total costs. Agriculture usually generates value added equal to 80 to 90 percent of the value of crops produced.

Recall that in this example there are only two tariff rates being applied, 50 percent on the goods produced and 35 percent on the inputs purchased to produce these goods. Without looking further it would generally be expected that each activity is getting roughly the same levels of protection since they face the same tariff rate structure. In reality, when ERPs are calculated, it turns out that very different incentives are being given (see Table 5, below). The low value added activities such as simple assembly have very high ERPs. In this simple example, the assembly industry has an ERP of 951 percent creating the potential for enormously high profits. At the other end of the spectrum, agriculture which has very high rates of value added produced has an ERP of only 52 percent.

Table 5
Indicative Average ERPs for Broad Industry Groups: Output Tariff 50%, Input Tariff, 35%

Industry Group	Assumed Value Added	Average ERP (%)
Assembly activities	1% to 3%	951.7
Light manufacturing	5% to 20%	**177.0**
Other manufacturing	20% to 30%	96.0
Raw materials	30% to 60%	69.8
Agriculture	80% to 90%	52.7
Note: See Annex B, "The Cascading Tariffs Trap", for further details on the assumptions on which this table is based.		

Most countries would view the incentives arising from this sort of simple escalating tariff rate structure as running counter to their core economic objectives. There are two reasons for this, one based on economic efficiency and the other on distributional grounds. Highly skewed incentives like those coming out of this example usually lead to resources being diverted to activities that appear to be highly profitable given the distorted prices resulting from the differential tariff rates effects on prices, and away from activities that may well be more economically profitable, including potential export industries.

This particular pattern of incentives also has adverse distributional implications. If a goal of economic policy is to reduce poverty, the typically large numbers of poor in agriculture and among the unskilled workers in basic industries are being severely disadvantaged relative to other activities. And even in those activities favored by the skewed incentives, it is usually the case that the artificially high profits generated by protection rarely go to the workers.

Now consider this example in the light of the problems usually encountered with implementing an import substitution strategy discussed above. In the initial stages of the strategy the duties on activities producing final goods, such as assembly and light manufacturing industries. At the same time tariffs on raw materials are kept low. The result is an even more skewed set of incentives emerging from the escalating tariff rate used in this example. Activities characterized by low value added become artificially much more profitable than they would otherwise be. It is easy to see why any attempts to continue implementing the strategy and raise tariffs would be resisted.

What is the remedy needed to remove these negative effects? Although it may be counterintuitive, the answer is to adopt a single, uniform tariff rate. This removes the leveraged impact that differential tariff rates have depending on the amount of value added associated with different types of activities. The result, illustrated in Table 6, is that if the tariff rate on all goods is 35 percent, all activities end up receiving ERPs more or less equal to 35 percent.[27](Note that there is a common misperception that if the tariff rates for inputs and outputs are equal, the activity has zero effective protection. Also note that if the tariff rates for inputs are higher than for outputs, the ERP is usually negative. See Athe accompanying paper for more on this.)

Table 6
Indicative Average ERPs for Broad Industry Groups: Output Tariff, 35%; Input Tariff, 35%

Industry Group	Assumed Value Added	Average ERP (%)
Assembly activities	1% to 3%	35.0
Light manufacturing	5% to 20%	35.0
Other manufacturing	20% to 30%	35.0
Raw materials	30% to 60%	35.0
Agriculture	80% to 90%	35.0
Note: For further details on the assumptions on which this table is based, see Annex B.		

[27] There are methodological issues in calculating ERPs that are ignored here, notably the treatment of non-tradable goods. There was an extensive debate in the economics literature on how non-traded goods should be treated in this sort of analysis. At least four approaches have been widely used, the Balassa and Corden Methods, the Modified Balassa Method and the Modified Corden Method. In the end both empirically and theoretically these issues do not seriously detract from the point being made here: that a uniform tariff rate leads to a largely uniform effective rate.

6.4 Reducing Tariff Escalation Under the NAMA Negotiations

The point of the preceding discussion has been to develop the rationale behind the objective in the NAMA negotiations to reduce tariff escalation. Consider again Figure 4 above that illustrated the impact on the tariff rate structures due to different values of the "B" parameter in the proposed nonlinear formula. It is clear from this that whichever value is used, the result will be a structure with less variation in tariff rates and consequently less variation in effective rates.

Jordan would benefit economically from reductions in the variations of tariffs and ERPs. The benefits would accrue both due to movement towards a system with lower distortions (i.e., more economically efficient) as well as improved distributional effects by reducing the rents received by protected industries.

7. Sectoral Initiatives

7.1 Background

Included in the work program for the NAMA negotiations is the possibility of agreement on sectoral initiatives where tariff reductions would be accelerated. Although there is as yet no agreement on how, or even if, this part of the process might proceed, there is the general expectation that it *might* be broadly similar to the *Information Technology Agreement* reached during the Uruguay Round. That is a voluntary agreement where countries have the option of committing to binding essentially all IT-related tariff lines at zero. Note that under the current NAMA process the question of whether sectoral initiatives would be voluntary in this way has not been resolved. In either case, if these initiatives go forward there would undoubtedly be additional flexibility for developing countries in how they would be implemented.

The intention is that these initiatives would include "products of particular export interest to developing and least-developed country participants." Based on this, it has been suggested that the following sectors may be included:

- Electronics and electrical goods;
- Fish and fish products;
- Footwear;
- Leather goods;
- Motor vehicle parts and components;
- Stones, gems, and precious metals; and
- Textiles and clothing.

In addition, the UAE has proposed a sectoral agreement for the complete liberalization of raw materials, including non-ferrous metals, with primary aluminum as the strategic priority. This proposal raises an interesting issue. By focusing on raw materials as a sector for more extensive and rapid liberalization this would tend to lead to more, not less tariff escalation. (Note that Chile's representative in the talks argued that tariff reductions should be neutral, pointing out that sectoral initiatives discriminated against sectors and therefore could distort the flows of investment.)

The NAMA work program suggests as a basis for negotiation a proposal that:

> *"sectoral tariff elimination shall be achieved through three phases of equal length. The basis for elimination will be from the bound rates after full implementation of current concessions, or for unbound items, the MFN applied rates in 2001. The tariff reductions will occur in equal annual stages, as follows:*
>
> - *developed participants and other participants who so decide, shall eliminate tariffs at the end of the first phase;*
> - *other participants shall achieve tariff reduction and elimination as follows: 1) tariff reduction to a proposed level of not more than 10*

percent[28] *at the end of the first phase; 2) maintain this level during the second phase; and 3) achieve elimination of tariffs at the end of the third phase."*

7.2 Considerations on Sectoral Initiatives for Jordan

As has already been noted by officials of the MIT, a sectoral initiative covering textiles and clothing would have the effect of eroding Jordan's existing preferential access for these goods to the US and EU markets. Presumably a number of producing countries would readily agree to join such an initiative as it would help to alleviate the impact of the elimination of Multi Fiber Agreement (MFA) quotas.[29] And while there would be some support from the textile sector in the United States, the apparel retail sector strongly opposes such a measure. Since the European Union has a significant number of internal apparel producers that can be expected to resist reductions in trade barriers, one would have to expect that the chances of any substantial sectoral for textiles and clothing being agreed are very low.

But policy makers in Jordan should also recognize that a broad sectoral initiative for textiles and clothing would offer the prospect of expanding the potential markets for exports from this country. Jordan already has in place substantial investment in supporting infrastructure and production capacity that is increasingly competitive relative to many other countries. There is no doubt that many existing producers would much rather maintain their preferential access to important markets rather than face a more competitive international market. Nevertheless, it should not be assumed that such an initiative would necessarily be all bad for the industry here.

More generally, Jordan can expect to continue to expand and develop its economy only through increased trade. In principle Jordan has little to gain in attempting to continue to protect its small local market for any of these goods while it stands to benefit substantially if given freer access to the much larger global market. If such initiatives are included on a voluntary basis, Jordan would likely find it in there interests to join such initiatives.

[28] If the rate (bound or in the case of unbound items, the MFN applied rate in 2001) is less than 10 percent, this lower rate shall remain in place.

[29] There have been a number of proposals to defer the ending the MFA scheduled 1 January 2005. However, the chances that this would take place are minimal. There are several large apparel producers that stand to gain from the ending of the MFA, including India and Pakistan as well as China that would resist such a measure at this late date.

8. Jordan as a Recently Acceded WTO Member

8.1 Background

The DDR process, including the NAMA work program, indicates that the particular concerns of newly acceded members to the WTO (i.e., those that have joined since 1995) would receive special consideration. For the most part this includes developing and least developed countries (LDCs) that have made what are viewed extensive market access commitments as part of the accession process. (Paragraph 9 of the Doha Ministerial Declaration notes that following countries have joined: China and Chinese Taipei, as well as Albania, Croatia, Georgia, Jordan, Lithuania, Moldova and Oman.)

These commitments include, *inter alia*, extensive coverage of tariff binding commitments as well as binding ceilings that are not substantially higher than applied tariff rates. Many of these countries are still in the process of implementing the commitments that were made and this will continue for a number of years. In Jordan's case, implementation of the accession commitments will continue until 2010.

The specific potential "concessions" for newly acceded members remain to be negotiated. Among the possibilities that have been mentioned are permitting a higher coefficient to be used in the nonlinear formula for tariff reductions, a longer implementation period than would otherwise be the case and/or a "grace period" that would permit implementation of DDR commitments only after the implementation of accession commitments have been completed.

The inclusion of China amongst the newly acceded members will inevitably complicate the negotiations on special provisions. There is intense global interest in gaining greater access to the large and growing Chinese market. And of course China is viewed as a highly competitive exporter of a wide range of goods. To the extent that any additional concessions are considered for newly acceded members as a group, there will be some reluctance to be very "generous" in permitting China to defer increasing market access.

In light of these considerations, one would have to expect that the most likely outcome of the negotiations on special provisions would be the third option cited above, agreement on permitting newly acceded members to defer implementation of new DDR commitments until after accession commitments have been fully implemented. (Informally it has been suggested by someone close to the discussions in Geneva that there is some reluctance in some quarters to support wide range of different values for the parameter to be used in the formula for reducing tariffs.)

8.2 Considerations for Jordan on Provisions for Newly Acceded Members

It is highly likely that as a newly acceded member that Jordan will have available one or more options that will permit substantially delaying the implementation of any commitments agreed as part of the NAMA-WTO process. Not only is it likely that any implementation would not begin before 2010, but it is reasonable to assume that as a developing country the likely "grace period" that would be available as part of the Special and Differential Treatment (STD) provisions that will be negotiated under the DDR would provide an additional period before any tariff reductions would begin. Based on past

agreements, one could expect that implementation of tariff reductions for developing countries would be deferred from three to five years. If this is the case, then Jordan would not be compelled to begin reducing NAMA MFN tariffs until 2013 to 2015. Once begun, the tariff process would likely be phased in over a number of years.

It cannot be emphasized too strongly that while opportunities to substantially defer further reduction and reform of Jordan's tariff rate regime will be available, accepting these provisions would not be in the economic interests of the country. There are several considerations that should encourage policy makers to forego delays and make use of the NAMA-WTO process to carry reforms forward more expeditiously.

- Between now and 2010/2014 the United States, European Union, Singapore and other preferential tariff rate reductions will be largely completed. As noted above, the greater the differences that exist between preferential and MFN tariff rates, the greater the scope for inefficient trade diversion to take place.
- Jordan's current cascading tariff rate structure is almost certainly creating distorted incentives that tend to distort investment and undermine productivity.
- Accepting opportunities to delay trade enhancing reforms are fundamentally inconsistent with the main thrust of Jordan's trade policies in recent years which have been aimed at establishing an open trade environment. Adopting a different direction at this stage can only undermine the confidence of potential investors.

Economists have long argued that the most rational approach for any country is to unilaterally liberalize its trade policies, not to limit its progress by adhering to a multilateral negotiating process.[30] Of course this can sometimes be difficult politically. It is possible to use bilateral and multilateral agreements as a means to provide political cover to further the process of reform. But there is often a danger of losing sight of the underlying economic interests of the country in a negotiation process engaged in the trading of "concessions".

[30] See, for example, the papers contained in the volume edited by Jagdish Bhagwati, *Going Alone: The Case for Relaxed Reciprocity in Freeing Trade*, The MIT Press, 2002.

9. Addressing the Impacts on "Sensitive" Sectors

9.1 Identification of Sensitive Sectors

A number of sectors have been identified as being particularly "sensitive" to further liberalization of trade policies. It is argued that this warrants continued protection from competing imports, in part by adopting a minimalist positing with respect to reducing tariffs under the NAMA negotiation process. Among these are:

- Jewelry,
- Furniture,
- Garments,
- Home appliances/electronics and
- Leather products, including shoes and bags.

These industries producing final products for local consumers are often among those designated for high protection in developing countries pursuing an import substitution industrialization strategy.[31] While the government's concerns about the impacts of adjustment in these industries is understandable, experience has shown that providing protection if far from the best approach. The most that can be hoped for is that it delays somewhat the time when adjustments are finally addressed; either to take the steps necessary to enable these firms to be able to compete effectively or they find other more profitable lines of business.

Most countries introducing reforms to reduce trade barriers have phased tariff reductions in order to give local firms adequate time to make internal adjustments. Firms almost never respond as policy makes hoped to prepare for increased competition.[32] Most often they used the time to do everything in their power to delay the tariff reforms even further. The good news is that tariff reductions are actually implemented, a surprisingly large number of those firms that had earlier assured policy makers that this would mean certain death for their firms, find ways to adapt rather quickly.

It is worth noting that most of the sensitive sectors listed above entail production of goods that have relatively low levels of local value added.[33] This usually means that incentives arising due to trade barriers (i.e., effective rates of protection) are relatively high, leading to very high implicit subsidies to producers at the expense of consumers. Protection in these cases is not only difficult to justify in terms of economic efficiency, but also in terms of equity.

In particular, protecting garment producers who sell into the local market would be particularly difficult to rationalize given that producers in Jordan have demonstrated their

[31] The accompanying paper in an annex, on cascading tariff rates discusses some of these issues in much more detail.

[32] This is based on the authors more than 25 years working with developing countries in designing and implementing trade and policy reform programs.

[33] The possible exception is leather products. It was not possible during this exercise to look at the operations of firms in these sectors. But it should be noted that it is quite often the case that shoe production entails importing uppers and soles and doing little more than stitching them together – adding very little value in the process.

ability to compete effectively in export markets. And for many types of clothing there are considerable economies of scale, clearly shown by the country's own garment exporters. Given Jordan's small domestic market it is unlikely that many significant producers could expect to produce garments at levels sufficiently high to make them competitive relying on local consumers alone.

Maintaining relatively high tariffs raises the prices that local consumers must pay for the goods produced by these sensitive sectors. These indirect taxes tend to fall most heavily on the poor and the middle class who typically must spend all or most of their incomes to get by. But these taxes are usually hidden, so there is usually little political pressure for relief. (In contrast firms receiving protection are usually well aware of the benefits and are well organized to apply political pressure aimed at maintaining trade barriers.)

9.2 Transitional Assistance to the Sensitive Sectors

If the government feels that there are compelling reasons to provide assistance to these sensitive sectors to allow them to better able adjust to a more open trade environment, there are much more cost effective ways to do this than through maintaining relatively high protection. Further study would be needed to design the most appropriate programs. But these could include features such as:

- facilitating and cost sharing technical assistance,
- facilitating access to loans aimed at introducing productivity improvements,
- targeted assistance to upgrade and retrain labor in these industries,
- working with these firms to explore the potential to enter export markets, and
- facilitating foreign investors that may be willing to join as partners with local firms.

Such programs have a much greater likelihood of being effective once it is made clear that the government is committed to implementing a more open trade environment. And these programs will almost certainly be far less costly than maintaining high tariff rates.

10. Integrating a NAMA Strategy: Specific Recommendations

A central theme of this report is that it makes much more economic sense for Jordan to use the NAMA negotiations, and indeed the broader negotiations under the DDR to strengthen the countries overall trade policies. The ongoing WTO process as well as the initiatives to enter into regional and bilateral FTAs should be seen as steps towards achieving a comprehensive and consistent trade policy regime that supports the country's wider economic objectives – not as isolated objectives themselves.

10.1 Establish National Economic Priorities

Trade policies are a tool that has far reaching economic impacts. Virtually all prices in the economy are affected directly and/or indirectly. Protecting domestic industries imposes burdens not only on consumers, but also on exporters, whether they are located in EPZs or are notionally exempt from taxes on trade. It is critical for overall economic performance to ensure that trade policies are consistent – not sending mixed signals – and have credibility.

The government should be clear in stating its economic priorities. Based on earlier statements, it seems quite clear that increasing economic growth and the process of economic development are Jordan's primary economic objectives. Poverty can only be reduced if there are more and better employment opportunities available. Real incomes will increase only if there is a sustained increased in the demand for labor. This requires sustained growth.

Taxes on trade have provided a source for government revenue. This will continue to be the case in the medium term. While revenues will remain a secondary objective of trade policy, these considerations should not be confused with attempts at providing protection for favored industries (i.e., incentives). Revenue requirements should be identified and the goal ought to be to meet these requirements while minimizing other negative economic effects. (Revenue issues are discussed further below.)

10.2 Establish Comprehensive National Trade Policy

The government should establish a comprehensive national trade policy, making clear how the various elements such as the WTO process, regional and bilateral FTAs and the fit within this broader framework. It is argued in this report that these should be seen as transitional measures to be used in developing a consistent, stable open trade regime. The different elements of the national trade policy should be clearly linked to achieving the broader national economic objectives mentioned above.

An explicit statement of the country's trade policy which lays out a realistic strategy for implementation is important if increased levels of foreign investment are to be realized. This is especially true if hopes to attract investment in business that must operate with a long time horizon. For that reason, trade policies should be credible, with little chance of changing course in the future. FTAs provide one way of 'locking-in' progress towards reforms. The WTO process, including the NAMA negotiations, can also be useful in building credibility by agreeing to reduce bound tariffs.

There is a danger with the WTO negotiating process of holding back tariff reductions in the hope that this can be used as leverage to induce other countries to offer increased market access. Many countries play this game with the result that many maintain higher tariff rates than suit their national self-interest. For Jordan, a small country, there is little to gain with such a strategy.

10.3 Greater Attention on Trade Facilitation

As tariff rates are reduced under existing commitments, other forms of non-tariff barriers (NTBs) will assume greater importance. The positive economic effects to be derived from trade liberalization will depend on how well these are addressed. The fundamental goal ought to be to minimize the costs of moving goods in and out of the country as well as ensuring that local businesses have full access to the information required to take full advantage of trade opportunities.

As the FTAs come to play a larger role, they bring with them a number of important trade facilitation challenges. Perhaps the most potentially troublesome are the requirements for documenting compliance with the rules of origin (ROO). This process typically entails issuance of certification by a national authority that the ROO have been met. There is much that can be done to reduce the time required and other administrative burdens in this process.

10.4 Positions in the NAMA Negotiations

This should not be addressed in isolation but seen as an integral part of the national trade policy framework. If, as argued here, to goal is to reduce MFN tariffs in line with reductions to be undertaken as part of existing FTAs, then the position ought to be to avoid seeking special exemptions, even if they may be available, (e.g., as a newly acceded member).

It is (or ought to be) irrelevant that Jordan and other newly acceded countries have made commitments that exceed the current positions of other member countries in terms of coverage of tariff bindings, etc. This is largely the consequence of long standing member countries failure to recognize the economic importance of adopting more open trade policies. (It is also a reflection of the short sighted tendency to play the WTO game of holding back commitments to be used subsequently as bargaining chips in negotiations.)

Jordan's economic growth and development depend on the ability to expand trade in the context of major geo-political challenges and severe natural resource constraints. The country is also vulnerable to external economic shocks, such as the increases in world oil prices. However, the ability of Jordan to expand trade and to respond to such shocks will only be undermined by slowing the process of trade liberalization.

Having said that, it is reasonable that additional commitments to reduce tariffs under the DDR should begin after the implementation of the commitments undertaken as part of accession is completed. Given what appears at this stage to be the shape of the likely outcome of the NAMA negotiations, this would still provide a relatively long timeframe within which to reduce tariff rates. Of course, nothing agreed under these negotiations will preclude Jordan from reducing tariff rates more rapidly.

10.5 Sectoral Tariff Component

The potential for sectoral tariff agreements, whether voluntary or not, raises issues of concern regarding the erosion of preferences under existing preferential agreements, such as FTAs. A possible sectoral agreement on textiles and clothing in particular would undermine the preferential access to the United States that Jordan now enjoys. Most of the other sectors that have been mentioned hold out the potential for some gain for Jordan, including electronics and electrical goods; fish and fish products; footwear and leather goods; motor vehicle parts and components; and stones, gems and precious metals.

While it *may* be the case that a sectoral agreement covering textiles and clothing would not be in Jordan's immediate interest, it should be recognized that the value of the existing preferences is likely to be eroded in other ways outside of the WTO process. Most of the countries adversely affected by the end of the MFA quota regime are seeking means to alleviate these consequences. The US Congress is considering measures to provide additional access to its market for least developed countries as well as for countries affected by the Asian tsunami. And the US government can be expected to use these sorts of measures to grant more favorable access to other countries as well, such as it has done recently with Egypt and the granting of the QIZ facility.

The evolving nature of global trade preferences reinforces the arguments made above, that FTAs and other similar arrangements should be viewed as transitional steps towards adoption of a permanent open trade environment. The United States, European Union, Japan and other major markets can be expected to continue to enter into preferential agreements with other countries which will also erode Jordan's existing preferences.

In light of these changes, it is likely that sectoral agreements under the DDR which would increase Jordan's access to markets globally would be in the country's economic interests. Simply put, if the major markets where Jordan now has preferential access are to be gradually opened to more potential competitors in any case, increased access to smaller markets through sectoral agreements would be a potential gain.

10.6 Revenues from Trade Taxes

A reliance on revenues from tariffs and other forms of taxation on trade has long been seen as an impediment to comprehensive trade reform in many countries. The potential loss of revenue is certainly an issue of concern for the Jordanian government. Revenues from import duties have fallen by 26 percent in recent years, from JD 274 million in 1999 to JD 202 million in 2003 (preliminary estimate).[34] This corresponds to a reduction from 15 percent of total revenues to 8 percent. It should be kept in mind that the average applied tariff rate, measured as total customs duties as a percentage of total imports, (JD 4,931 million) amounted to only 4 percent in 2003.

The fall in the share in total revenues of trade taxes also reflects the increased importance of the Goods and Services Tax (GST), for which revenues increased by 60 percent. The

[34] IMF, "Jordan: Selected Issues and Statistical Appendix", May 2004.

GST now accounts for nearly three times the revenue received through customs duties. (In 1999 ,customs duties were equal to 73 percent of GST collections.)
Regardless of the outcome of the DDR, it is inevitable that revenues from import taxes will continue to decline significantly.[35] More than 70 percent of current imports come from countries where there are trade agreements now in place (United States, European Union, Singapore) or are being put in place (the Middle East). As tariff reductions for imports from these sources are implemented, it is to be expected that the share of goods coming from these countries will only increase. It is impossible to make a precise estimate as sufficiently detailed data are not available, but based on very rough measures, it would not be surprising if the share of imports from countries with preferential trade agreements were to increase to 80 percent or more.

Some degree of substitution towards imports subject to preferential rates would take place as long as existing higher tariffs remained in place for imports from countries without preferences. It should be kept in mind that MFN duties are also being reduced as part of Jordan's WTO accession commitments, which would of course reduce substitution in this way.

While tariff rates under the FTAs will be virtually eliminated over the next five to ten years, it is impossible to predict to what extent imports from these countries will comply with the ROO and would be eligible for the lower preferential tariff rates. However, given the far larger size and degree of diversification of the US and EU, it would have to be assumed that a very large proportion of these exports will in fact comply with the ROO.

It is also cannot be determined from the data to what extent imports are destined for the FTZ or would otherwise be exempt from duties. The largest source of imports outside the coverage of preferential agreements is China – a source of some concern to some policy makers. However, it does appear that *at least* half of the imports from China are comprised of textiles and parts for machinery and equipment. This at least suggests that a substantial share of China's exports to Jordan is not exempt from import tariffs.

It is difficult to imagine a situation in which tariff revenues would not fall to a small fraction of the current amount, given the tariff rate reductions already being implemented. If as appears likely, some 80 percent or more of imports are duty free under preferential agreements and a substantial share of the remainder are exempt or subject to very low duties either because they are imported by exporters or are inputs used by local producers and thus subject to zero rates – then import duties as a source of revenue will no longer be of much consequence. The import base on which duties are levied would be extremely small and continuing to shrink.

Policy makers should consider at what point the costs incurred in collecting these rapidly diminishing revenues outweigh the benefits of the revenues received. These costs include

[35] An attempt was made during the course of this exercise to develop estimates of the likely loss of revenues due to the implementation of the FTAs and alternative outcomes to the NAMA negotiations. Detailed data, particularly for revenue could not be obtained. In any case, in light of the large changes in the tariff rate structures and the great difficulties assessing the effects that factors such as the ROO may have in trading patterns, it is unlikely that such analysis would be very helpful. Any estimates of tariff revenues rests upon the assumption that next year's trade will look much like this year's, an assumption that looks to be particularly weak in the present context.

both the direct administrative costs as well as the indirect economic costs incurred by importers. If some imports are to continue to be taxed, the government should consider moving towards a uniform rate of duty. This is an approach followed by a number of countries; perhaps the most well known example is Chile, where there is a single rate of 4 percent that applies to all non-preferential imports. This greatly reduces the economic costs resulting from distorted incentives leading to the misallocation of resources. (See Annex B for more on this issue.)

11. Next Steps and Further Work

11.1 Comprehensive Trade Policy Strategy

There are at least two areas where further work on trade policy issues would seem to be warranted. The most urgent would be the development of a comprehensive statement of Jordan's trade policy strategy and objectives with a clear indication how these are to be achieved using the various initiatives. The objectives of trade policies should of course be closely linked to the country's national economic objectives.

Like many countries, trade policies in Jordan are developed or at least influenced by a number of different agencies and private groups. Trade policies have impacts throughout the economy, so every group has some interest in the outcome. Inconsistencies and imbalances inevitably result. The process of bringing together these groups and formulating a consistent and coherent trade policy statement can be quite useful in itself.

Such an exercise will likely raise issues where one group's interests must be balanced against another's, (e.g., consumers versus firms in protected sectors). One approach in addressing these issues that has proven effective is to ensure that an economy-wide perspective is adopted throughout – assess the total costs and benefits resulting from policy throughout the economy, rather than on a narrow sectoral basis. For example, this was the approach taken over the years in Australia by the Industry Assistance Commission (later the Productivity Commission). The government might find it useful to look more closely at the work that was done by this body.

After a National Trade Policy is formulated, periodic reviews should be undertaken to report on its implementation. This would help to lend credibility to the government's policies – important for promoting increased investment.

11.2 Monitoring of Effects of Trade Policies

A second area where further work would be warranted would be the analysis and monitoring of the incentives effects of trade policies. This can be a useful tool for reducing the scope for inappropriate and sometimes unintended incentives (or disincentives) resulting from changing trade policies. For example, it would seem that that no analysis of effective rates of protection has been undertaken. This analytic framework can be used to look at the differential effects of tariffs, consumption and excise taxes and even NTBs at the firm/industry level.

Annex A Tariff Reductions Under the JUSFTA

The NAMA negations on tariff reductions should be viewed against the agreed phased tariff reductions that are taking place under the Jordan-United States Free Trade Agreement (JUSFTA). Under this agreement, virtually all tariffs will be eliminated by 2010.

The JUSFTA (Annex 2) establishes five "Staging Categories", each corresponding to a different period over which tariffs will be eliminated.[36] In four cases, Staging Categories A through D, reductions are in equal reductions and begin in the first year of the agreement,

- **Staging Category A**: Where tariffs are eliminated over two years. This group includes 1096 tariff lines (20.3 percent of all lines), virtually all of which with a base rate of 5 percent.

- **Staging Category B**: Where tariffs are eliminated over four years. This group includes 869 tariff lines (16.1 percent of all lines), all of which have a base rate of 10 percent.

- **Staging Category C**: Where tariffs are eliminated over five years. This group includes 218 tariff lines (4.0 percent of all lines), virtually all of which have a base rate of 20 percent.

- **Staging Category D**: Where tariffs are eliminated over ten years. This group includes 1927 tariff lines (35.7 percent of all lines), virtually all of which have a base rate of 30 percent.

- **Staging Category E:** Where tariffs will be reduced according to Jordan's existing WTO accession agreement. There are 1291 tariff lines in this group (23.9 percent of all lines). Within Jordan's lines in Staging Category E, there are five different base rates, distributed as follows:

0%	1064 lines	(82.4 percent)
5%	69 lines	(5.3 percent)
10%	79 lines	(6.1 percent)
20%	5 lines	(0.4 percent)
30%	75 lines	(5.8 percent)

As a result of this process virtually all tariffs on trade with the US will be eliminated within the next five or six years.

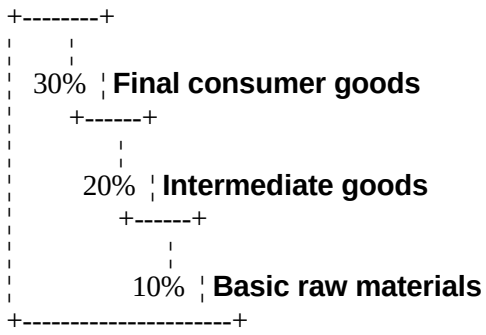
[36] Note that this Appendix considers only NAMA goods, HS chapters 25 through 97. There are two additional Staging Categories "I" and "M". Staging Category M covers only passenger vehicles, including 30 tariff lines, where the reduction of tariffs will begin in 2004 and be completed by 2010.

Annex B The Cascading Tariffs Trap[37]

1. Introduction

A *cascading* tariff system is one where there are several (or more) rates or bands in which the *relative* rates are intended to correspond to the stages of production or the degree of fabrication. This usually means that the highest rates are levied on final goods, lower rates applied to intermediate goods and the lowest rates to raw materials and capital goods. The structure of tariff rates illustrated in Figure 1 is typical. But is this a problem? Although this approach might seem to be straightforward and sensible, in fact it leads to serious difficulties in practice and represents a major impediment to achieving an effective policy environment conducive to rapid and efficient economic growth. While there are usually exceptions to this pattern, this has been the basic structure of the tariff system for many years by many countries, including Jordan.[38]

Figure 1: Cascading Tariff Rate Structure



Officials in many countries find themselves laboring with a cascading tariff system for reasons that may have been forgotten. Indeed, this approach has been so widespread, for so long that it is often no longer questioned and has become seen as a part of the natural order of things. But, as countries have proceeded to simplify their trade policies and reduced the number tariff bands, maintaining a cascading approach has become more and more difficult in practice. As a result, tariff setting commissions end up spending a great deal of time and effort trying to accommodate what are basically inconsistent approaches to setting tariffs. One of the more difficult aspects of this problem is finding a way to break free from cascading rates as a guiding principle, (hence the title of this paper).

The main goals of this exercise are to examine the economic implications of a cascading rate structure and to consider a way out of this "trap". In the next section, the nature of the cascading structure and the reasoning behind its adoption are briefly considered. The implications of cascading tariffs for economic incentives are then analyzed. It is argued that

[37] Prepared by author. This paper is adapted from an earlier policy briefing note and is intended for technical background purposes only. Any explicit or implicit policy statements included are not necessarily meant to apply to Jordan and should not be taken as recommendations, but are illustrative of the sorts of issues that have arisen elsewhere.

[38] See, for example the various papers in Papageorgiou, Michaely and Chocksi, *Liberalizing Foreign Trade*, Basil Blackwell, Oxford, 1990 and 1991.

one of the key steps in solving this problem is shifting the focus of policy makers from nominal tariffs to effective protection. This and other issues are examined in the final section.

2. The Origins of Cascading Tariffs

The cascading approach to setting tariff rates was widely adopted roughly 25 to 30 years ago and is still used, especially (but, not exclusively) in many developing countries. To understand the strength of its appeal as well as several of its drawbacks, it is necessary to understand the context in which it developed.

2.1 Import Substitution Strategies

Before governments in many developing countries began to actively encourage industrial development in the 1960s, tariffs were primarily used as a means for raising revenue. Rates were typically low and applied more or less evenly across different types of goods. However, with the adoption of industrialization strategies based on import substitution, tariffs began to be used more prominently to provide incentives (i.e., effective protection) for selected activities.

In the early stages of this strategy, simple consumer goods manufacturing activities were viewed as the easiest targets for industrial development and the tariffs for these goods were raised *relative* to those for other goods. The original intention was that as these *infant industries* matured, more types of final good manufacturers would be targeted and their tariff protection increased.[39] These were to be followed by increased protection for the domestic production of intermediate goods, processed raw materials and capital goods in subsequent stages, thus fostering industrial backward linkages.

As experience over the last thirty years amply demonstrated, this approach had serious flaws and the results were not as hoped. The first stage of the strategy was implemented and high levels of protection were established for many types of final goods. But, in doing this the seeds of failure were sown. Many of these "first stage" firms remained uncompetitive, which made it politically difficult to proceed to a second stage where the tariffs for the intermediate goods used by these activities would be increased. In retrospect, it is clear that these highly protected firms actually had incentives *not* to become more competitive because any improvements that they might have made would have been rewarded by lower incentives, (i.e., reduced effective protection as a result of higher duties on their inputs). Thus, it was usually more profitable for these firms to apply themselves to maintaining the subsidies that were being received through high protection. As a result, a powerful constituency was created that was able to block effectively further implementation of the import substitution strategy.

Another significant outcome of this approach has been the widespread view that tariffs on outputs *should* be higher than the rates that apply to inputs -- the cascading principle. Indeed, it is often asserted by business people, in the press and by some policy makers that firms would not receive any "protection" (or sometimes any effective protection) if this principle is violated. This is not true, as will be shown below. However, the fact that this is so widely

[39] Throughout much of this discussion, the terms tariffs and protection are used interchangeably.

believed makes it one of the most difficult hurdles to be overcome in breaking out of the cascading trap.

Thus, the cascading tariff structure that persists today in many places is a holdover from an import substitution industrialization strategy that has been largely abandoned. In fact, one of the primary reasons that the import substitution approach has not worked well, the ability of highly protected "first stage" activities to retain their favored treatment and block progress, has become one of the chief difficulties in breaking away from the former policies and adopting an alternative strategy, (i.e., *"It hasn't worked, but still can't be changed."*) In the process, the myth of the universality of the cascading tariff principle has grown to the point where the burden of the argument rests with those that would adopt a different approach.

3. The Implications for Economic Incentives

The following discussion might be clearer if we use as an even simpler example of a cascading rate structure than illustrated in the first section. Thus, it will be assumed then that "current" tariffs are set on the following basis:

50%: final consumer goods; and
35%: intermediate goods and raw materials.

As noted, the underlying reason for adopting this type of tariff rate structure was to increase the economic incentives for producers of final goods. The best measure of the incentives provided by tariffs is the *effective rate of protection (ERP).*[40] To see how this works, we will work through the calculation of the ERP for a "typical" firm that produces shoes. The local producer is able to charge a price that is 50 percent above the *world price* (i.e., the CIF price of imports). Put another way, the *nominal rate of protection (NRP)* for shoes is 50 percent.

Let us assume that a pair of shoes that can be imported for JD 100, before the tariff is imposed. These are produced using one pair of soles and uppers that are also imported and costing JD 85 before tariffs. At the assumed "current" tariff rates, the local price of the shoes would be JD 150 and the soles and uppers used as inputs cost the producer JD 114.75. (These costs are summarized in Table 1.) The resulting value added measured in world prices is JD 15. When the effects on domestic prices are taken into account, value added is JD 35.25. It follows then that the ERP is 135 percent, (i.e., the proportion by which value added measured at domestic prices exceeds value added at world prices).

Table B.1
Cost Structures at "Current" Tariff Rates (JD and percentages)

	World Prices	Tariff Rates	Domestic Prices
Shoes	100.00	50%	150.00
Soles and uppers	85.00	35%	114.75
Value added	15.00		35.25

Effective rate of protection: 135%

[40] Throughout this discussion it will be assumed for simplicity that tariffs provide the only form of trade barriers and that there are no offsetting commodity (e.g., excise) taxes. This assumption does not change the substance of the points made in any way.

- *This demonstrates that a cascading rate structure will lead to an effective rate of protection that is higher than the tariff rate on the output (i.e., the nominal rate of protection).*

This is an example of one hypothetical activity and it is worth considering how this analysis would change under different conditions. There are two factors that can be varied: the value added of the generated by the productive activity and the relationship between the output and input tariffs.

3.1 Changes in the Value Added Ratio

It should be stressed that the level of value added generated by an activity cannot be directly controlled by policy makers, but results from the scale of production, technology, etc, and is largely an exogenous characteristic.[41] However, different types of productive activities are generally characterized by different value added ratios, (i.e., value added per unit of output, or in the example above, 15 percent, or JD 15/100). Broadly speaking, simple assembly activities are often characterized by quite low value added ratios (e.g., 1 percent or 2 percent are not unusual and *negative* value added is common); most manufacturing of consumer goods typically exhibits value added ratios in the range between 5 percent and 30 percent; manufacture of intermediate goods and processing of raw materials usually have somewhat higher value added ratios, commonly between 20 percent and 60 percent; and agricultural production ordinarily is characterized by quite high value added rations, in excess of 80 percent.[42]

Therefore, we examine how ERPs *based on a given set of tariffs* are affected by these underlying differences in value added characteristics. Estimates of effective rates of protection were made for value added ratios (measured at world prices) between 1 percent and 99 percent. Consider first the effects of different levels of value added on ERPs for the tariff rates used in the previous example, (i.e., 50 percent for outputs and 35 percent for inputs, see the third column of Table 2 below). With an extremely low value added ratio, 1 percent, the resulting ERP is enormous, 1,535 percent. As the value added ratio increases, the ERP falls, sharply at first (e.g., a 15 percent value added ratio yields the ERP of 135 percent obtained in above example.) As the value added ratio gets larger, the impact on the ERP declines because this reflects the decreasing amount of raw materials used. (If *no* inputs are used, that is the entire output represents value added, the nominal and effective rates of protection are equal, in this case, 50 percent.) This is shown more clearly in Figure 2. Thus, to summarize,

- *The same cascading tariff rates can lead to very different incentives depending upon the value added of the activity. And, these differences will be greater, the lower is value added.*

[41] These factors can be influenced to a limited degree by policies, but the impact is indirect and usually takes a good deal of time.

[42] The latter reflects the fact that value added includes the returns to land as well as labor and capital.

Figure 2
Simulated Effective Rates of Protection -- With Variable Input Tariff Rates

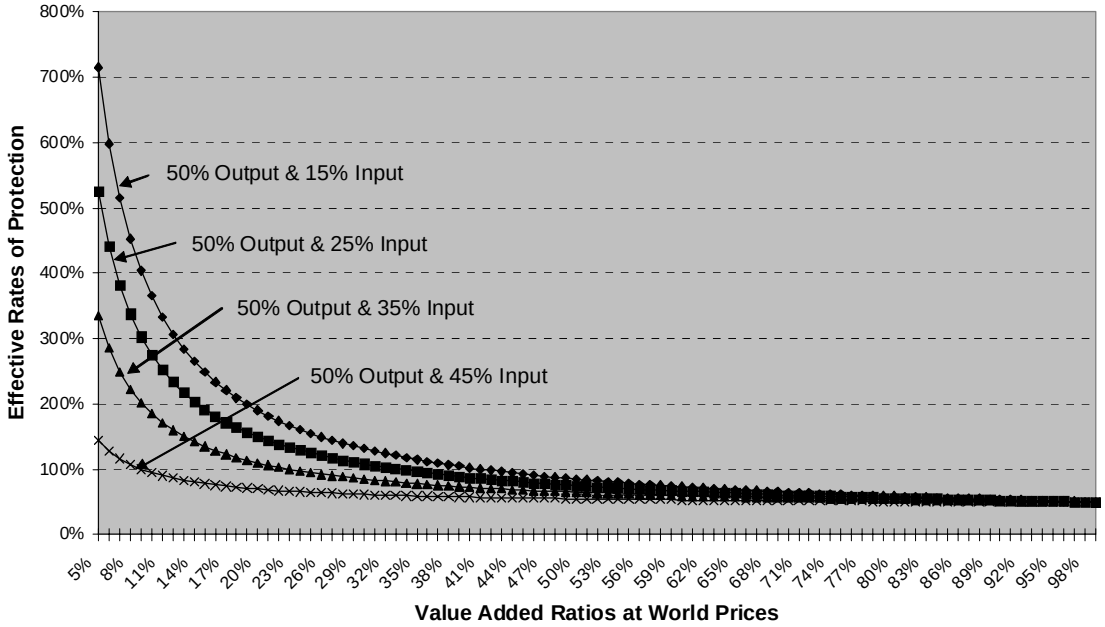


Table B.2
Simulated ERPs -- Variable Input Tariffs
(Percentages)

Value Added Ratio	Tariff Rates: Outputs/Inputs 50%/15%	50%/25%	50%/35%	50%/45%
1%	3,515.0	2,525.0	1,535.0	545.0
5%	715.0	525.0	335.0	145.0
15%	248.3	191.7	135.0	78.3
20%	190.0	150.0	110.0	70.0
40%	102.5	87.5	72.5	57.5
60%	73.3	66.7	60.0	53.3
80%	58.8	56.3	53.8	51.3
99%	50.4	50.3	50.2	50.1

3.2 Changes in Relative Tariff Rates

The impact of changing the *degree of cascading* (i.e., relative tariff rates) is examined by adjusting the tariff for inputs keeping the rate for outputs constant at 50 percent. The estimates, presented in Table 2 and Figure 2, show that the *greater the degree of cascading*, or the difference between the tariff rates for outputs and inputs, the *higher will be the ERP* for a given value added ratio.[43] For example, increasing the duty on inputs from 15 percent to 45 percent leads to a corresponding fall in the ERP from 715 percent to 145 percent (with a 5 percent value added ratio). It is also evident from these estimates that this "leveraging" effect

[43] The relative difference between cascading rates is sometimes referred to as the "gradient" of the rate structure and reflects its steepness.

of cascading rates is greater, the higher the usage of intermediate inputs in production, (i.e., the lower is the value added ratio). Thus, for an activity with a high value added ratio, say 80 percent, raising the duty for inputs from 15 percent to 45 percent only reduces the ERP from 58.8 percent to 51.3 percent.

It is worth examining briefly how the *same degree of cascading* will affect incentives with *different levels of tariff rates*, (i.e., varying the level of output tariffs). To do this we have made estimates based on a wide range of output tariffs but with a *constant 15 percent differential* between the tariffs for outputs and inputs, (see Table A3.3 and Figure 3).

Figure 3
Effective Rates of Protection -- With Constant (15%) Tariff Rate Differentials

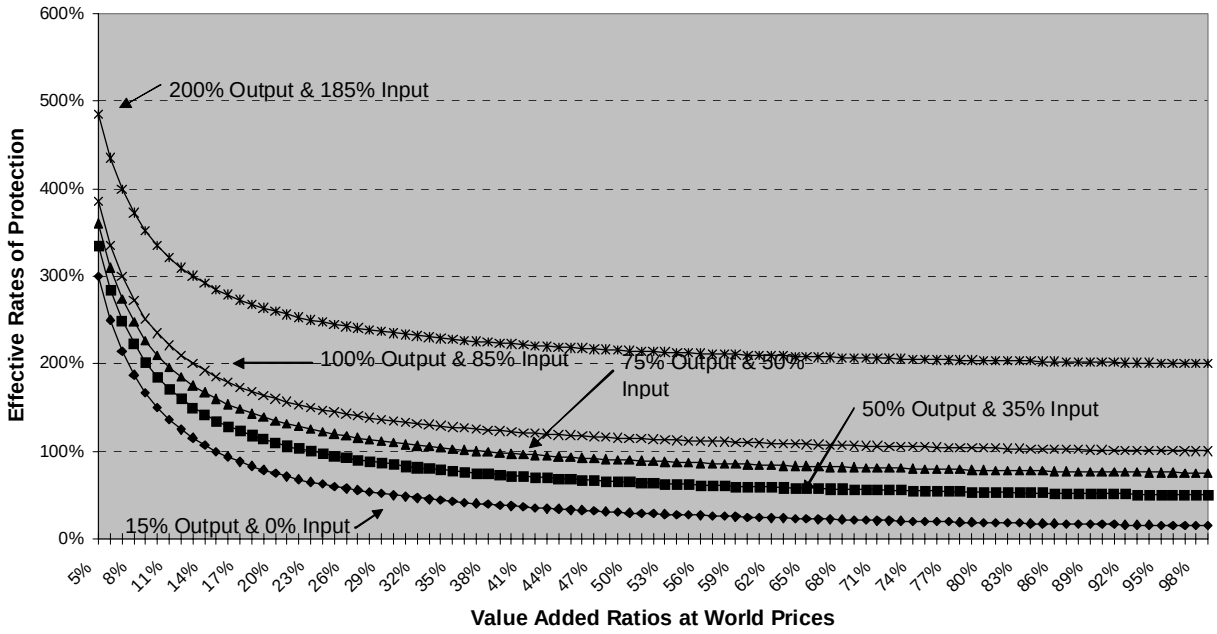


Table B.3
Simulated ERPs -- With Constant (15%) Tariff Rate Differential
(Percentages)

Value Added	Tariff Rates: Outputs/Inputs				
Ratio	15%/0%	50%/35%	75%/60%	100%/85%	200%/185%
1%	1,500.0	1,535.0	1,560.0	1,585.0	1,685.0
5%	300.0	335.0	360.0	385.0	485.0
15%	100.0	135.0	160.0	185.0	285.0
20%	75.0	110.0	135.0	160.0	260.0
40%	37.5	72.5	97.5	122.5	222.5
60%	25.0	60.0	85.0	110.0	210.0
80%	18.8	53.8	78.8	103.8	203.8
99%	15.2	50.2	75.2	100.2	200.2

There are several observations that can be made concerning these results:

- ***The same degree of cascading (i.e., a constant differential between input and output tariffs) yields ERPs that are broadly <u>similar</u> for activities with low value added, even with quite large differences in output tariffs.*** However, as intermediate goods inputs play less and less of a role and value added increases, relative differences in ERPs correspond more closely to the differences in output tariff rates.

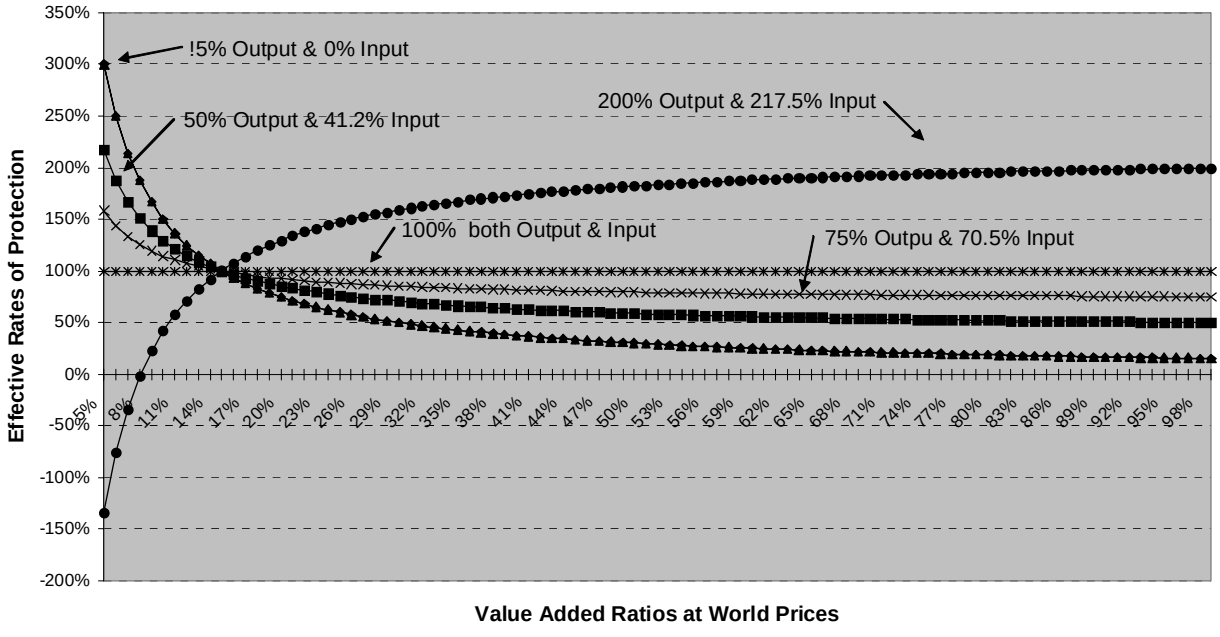
- ***Quite <u>low tariff rates</u> can yield very <u>high effective rates of protection</u>.*** For example, a 15% output tariff, no duty on inputs, with a value added ratio less than 15%, results in ERPs that are greater than 100%.

- ***Very <u>different combinations of tariff rates</u> can result in the <u>same ERP</u>.*** For example, the following output/input tariff combinations all yield a 100% ERP with a 15% value added ratio:

Tariff Rates	
Outputs	**Inputs**
15%	0%
50%	41.2%
75%	70.5%
100%	100%
200%	217.5%

As Figure 4 clearly shows, while these combinations would all produce the same ERP for an activity with a 15 percent value added ratio, they would lead to very different incentives for activities characterized by different value added ratios

Figure 4
Effective Rates of Protection -- Constant ERP at 15% VAWP



To conclude this discussion, the "rules" governing the relationship between tariff rates and ERPs can be summarized.[44]

[44] Under more general conditions, for example where nontraded input are used in production, the following "rules" need to be modified somewhat. Nevertheless, as a practical matter, these principles will still hold true to a reasonably good degree.

i ***If the tariff for outputs is greater than the tariff rate for inputs, the resulting ERP will be higher than the tariff rate for outputs -- for all levels of value added.*** This has demonstrated throughout the previous analysis.

ii ***If tariff rates for inputs and outputs are equal, the ERP will be equal to the common tariff rate -- for all value added ratios.*** This is illustrated in the example above where the tariff rates for inputs and the output were both set at 100%, (see Figure 4). And,

iii ***When the tariff rate for inputs is greater than the rate for the output, the ERP will be below the output tariff rate.*** This might be termed "reverse cascading" and was demonstrated in the above analysis where the tariff rate for inputs (217.5%) was larger than the rate for the output (200%), yielding an ERP of 100%. It should be pointed out that this shows that input tariff rates greater than the output tariff rate do not necessarily lead to negative effective protection (or "*disprotection"*).

3.3 Implications for the Pattern of Economic Incentives

To conclude this section we will use the previous analysis to gain some insight into the effects of a cascading tariff system for the industrial pattern of economic incentives (ERPs) that might result. This is important because ERPs provide signals that influence investors' choices of activity. *It is not widely appreciated that the cascading structure of the tariff rate system can have as much, or more, impact on the pattern of incentives as the levels of tariffs.* Thus, although tariff reforms may substantially reduce rates across the board, the effect on incentives may not be nearly as great as might be expected.

To isolate the possible sectoral impact of cascading tariffs, we begin by making assumptions concerning the value added characteristics of broad industry groups. These are based on experience, largely in other countries, and are meant to be indicative in nature. It should be kept in mind that observed value added ratios typically vary a large amount, even between firms in the same industry. (This reflects a number of factors, including difficulties with accounting data, transitory price effects, etc.) Nonetheless, general trends can be identified and these can be used for present purposes. The assumed ranges of value added ratios for broad industry groups are indicated in Table 4. The corresponding ERP estimates, based on a 50% tariff for outputs and 35% for inputs, were then averaged over the value added range to obtain an (unweighted) estimate of the sectoral average ERP.

Table B.4
Indicative Average ERPs for Broad Industry Groups:
Output Tariff: 50%; Input Tariff: 35%

Industry Group	Assumed Value Added	Average ERP (%)
1 Assembly activities	1% to 3%	951.7
2 Light manufacturing	5% to 20%	177.0
3 Other manufacturing	20% to 30%	96.0
4 Raw materials	30% to 60%	69.8
5 Agriculture	80% to 90%	52.7

Note: See text for the assumptions on which these are based.

These results suggest that even if <u>all</u> domestic activities were subject to the same cascading tariffs, there would still be a strong bias in the structure of incentives. Although this analysis is only broadly indicative, the results correspond reasonably well with experience in Sri Lanka and elsewhere. Furthermore, the previous analysis makes clear that much the same bias would result if the output and input tariffs were 15% and 0% or 100% and 85%.

The bias inherent in this type of cascading tariff structure works in favor of low value added activities, whether they are assembly industries or producing intermediate goods. However, in principle, a system biased in the other direction, in favor of high value added industries, would be no more desirable for promoting efficient industrial development. If an economy can undertake low value added activities very efficiently, (e.g., post-war Japan) these industries may provide a firmer basis for rapid industrialization than inducing investment in high value added industries. Thus, the major drawback of this type of bias in incentives is not so much that it disproportionately rewards low value activities, but that it distorts investment decisions in a way that does not correspond to economic efficiency and comparative advantage. The shortcomings of a cascading tariff rate system may be apparent, but how do policy makers make the transition to a more useful approach?

4. Breaking Away from the Cascading Tariffs Trap

The first step in moving away from a cascading tariff structure is to define clearly the type of rate structure that would best serve the country's economic development objectives. Usually these would include higher rates of growth and development, based on the expansion and diversification of exports and improved competitiveness of import competing activities. These goals must be tempered with the government's need for raising revenue, especially where a significant portion of which is derived from import duties.

If these economic objectives are to be achieved to any significant degree, resources must be employed in their most productive uses. The dominant role of the private sector in allocating resources means that it is essential that policy-based incentives do not distort their assessment of the returns from alternative investments. In other words, the large differences in ERPs need to be substantially eliminated. In light of the previous analysis, this indicates that the primary policy objective for the tariff system should be the adoption of a *low and uniform* rate structure.[45] In the remainder of this discussion it will be assumed that movement towards a low and uniform tariff rate an the accepted goal. Furthermore, it will be assumed that this cannot be done immediately.[46] Therefore, two crucial issues must be addressed: *What steps can be taken immediately to reduce, or at least control, the difficulties of a cascading tariff system?* And, *how should the transition from the present system be handled?*

[45] It is not possible to examine these issues in great detail in this paper. For example, there are other aspects of the existing tariff rate system that adversely affect exports. Thus, a low, uniform tariff is a widely viewed as an important element of establishing an outward oriented policy framework. It should be noted that other countries undergoing similar liberalization reforms have successfully adopted this approach, (e.g., Chile has had a uniform tariff of 11 percent that is being reduced to 7 percent, Ghana adopted a uniform tariff of 15 percent).

[46] Again, this is an issue that goes beyond the scope of this paper and will treated more extensively elsewhere. There are, nevertheless, compelling reasons why such a transformation should be undertaken relatively rapidly.

4.1 Immediate Steps

Establishing an Effective Rate Framework

A critical step in this process is putting greater emphasis on the *outcome* of the tariff setting process, the resulting effective rates of protection, and less on the tools being used, tariff rates. Jordan has made much progress in this regard, however it would appear that more could be done. Evidently estimation and analysis of ERPs and their implications has not been done. But even in countries where this has been done and objectives are stated in terms of achieving appropriate ERPs, it is not unusual for the day to day process of setting tariffs tends to focus on accommodating the existing cascading tariff structure. This is understandable because tariff issues typically deal with one (or a few) rates at any given time and policy makers set tariffs, not ERPs. Thus, it is probably unavoidable that tariffs will be determined on an *ad hoc* basis until an incentives based framework for setting tariffs is more firmly established.

The most effective way to introduce such a framework would be to proceed as follows:

- Establish publicly that henceforth tariff rates will be set with regard to their impact on ERPs. A "maximum acceptable" ERP would then be determined, say 25 percent, taking tariffs and all taxes into account. (It should be made clear that this may be adjusted in the future to a more suitable long term level.)

- As a matter of policy, there would be no changes in tariffs that would lead to ERPs above this level.[47] This requires that an agreed method for calculating the ERP be established and made available publicly. (This will also entail ensuring that adequate technical capabilities are available within the tariff setting authority for this analysis.)

- As a practical matter, a minimum ERP, say 10 percent, would also need to be established. Tariff changes would not be made that would reduce an activity's ERP below this level. This is only likely to arise when tariffs for raw materials and intermediate goods (i.e., goods used by other producers) are being considered.

- The formal process for accepting and evaluating requests for tariff changes needs to be adjusted to reflect these criteria. This process should be timely and reasonably transparent to permit all affected parties access, particularly when tariff changes affect the ERPs of more than one activity.

This will not, in itself, eliminate the all of the difficulties associated with maintaining a cascading rate system. However, it should contribute substantially to controlling the pressure for tariff increases and greatly reduce the number of tariff changes that result.

4.2 Transitional Steps

In parallel with the adoption of an ERP-based tariff setting procedure, a schedule for a program of rate adjustments needs to be established for the move to a uniform rate system.

[47] In principle this assessment should be made on the basis of the industry rather than for the particular firm. Otherwise, decisions may be based on the least efficient firm in an industry. There is also an important issue regarding the data requirements for this process. Implicit in these proposals is the development of a strong monitoring and analytic capability.

While the most straightforward approach would be to make this move in one step, politically this is likely to be difficult. In this context, a two stage process might be the most effective. For this discussion, it will be assumed that the target uniform rate would be 20 percent.

There are two different approaches that have been used in this type of tariff exercise: *tops down* and *tops down/bottoms up*. In the former, only high tariffs are reduced while low rates remain at present levels. In contrast, the latter amounts to a "concertina" adjustment, simultaneously reducing the highest rates and increasing the lowest rates. The *tops down/bottoms up* approach has the advantage of reducing the degree of cascading more rapidly. However, it also has a higher likelihood of greater variation in the resulting ERPs. (Further analysis of the possible effects of both approached can be carried out.) Nonetheless, since achieving a uniform tariff rate will mean that some rates will have to be increased, the question is really at what stage low rates should be increased.

Although further details would need to be worked out and analysis undertaken, this process probably should use a "tops down" approach in the first stage. In this, the all tariffs above 35 percent would be reduced to this level.[48] Whether the existing 35 percent rates should also be lowered, thus retaining a greater degree of cascading, should be considered. It would depend upon whether low rates are also being increased as well as the speed and scope of the reform program. (I.e., if a move to a uniform 20 percent rate were to be accomplished in, say, two years, then the adverse consequences of reducing 35 percent rates, perhaps to 25 percent, might be more easily accommodated.) In the second stage, all rates would be set at the target rate of 20 percent. Thereafter, tariff rate policy would be discussed in terms of adjusting the uniform rate.

A final comment on these reforms should be offered. In many countries a great deal of time and energy, by both the government and business, is devoted to setting tariff rates. (This is not surprising given the high rents associated with getting favorable treatment.) As a result tariff policy has assumed a high degree of political sensitivity. The difficulties in implementing substantial changes like those considered here may seem enormous. However, in those countries that have successfully reformed tariff policy, the transition has generally been far easier and with more positive results than had been expected. Tariff issues quickly recede and energies are redirected.

[48] The issue of adjusting the tariffs for textiles will need to be addressed. It appears likely that specific rates for textiles will be changed to 100% ad valorem rates in the near future. It is clearly desirable that these rates be made consistent with the rest of the tariff rate system as rapidly as possible.